INDEX

	Page
Prior opinions	1
Jurisdiction	1
Question presented	2
Statutes and regulations involved	2
Statement	3
Summary of argument	8
I. The advance receipts	8
II. The future installments	13
Argument:	
Introduction	13
I. The advance receipts	18
The Studio's method of accounting, deferring the accrual and reporting of compensation received in the taxable year in order to reflect related service expenses to be incurred in a later year, was properly rejected by the Commissioner and both courts below as violating settled tax accounting principles	18
A. The Studio's transactional method of accounting does not reflect its taxable net income for each taxable year	18
1. Under the annual accounting rule and related accrual principles gross income items must be reported in the taxable year in which the right to receive them becomes fixed, and deduction items in the year in which the liability to pay them becomes fixed	18
2. The Studio's accounting system violates the annual-accounting rule and related accrual principles	36
(a) The transactional or "earned income" method of accounting urged by the Studio	36
(b) Commercial accounting practices	44
(c) The Treasury regulations	50
(d) The decisions relied upon by the Studio and amicus	52

Argument—Continued
I. The advance receipts—Continued
The Studio's method of accounting, etc.—Cont.
B. Congress has authorized only two classes of taxpayers to use a deferral method of accounting for prepaid service income, and the Studio admittedly does not fall within either class ..... Page 56
C. Assuming *arguendo* that taxable income may be computed on a transactional rather than an annual basis, the Studio's method of accounting was properly rejected as even more artificial than that rejected in *American Automobile Assn. v. United States* 62
II. The future installments 65
The Studio was required to accrue and report future installments representing services rendered during the year (regardless of the contractual date for payment) and future installments due under the contract during the year (regardless of the contractual or actual date of performance) 65
Conclusion 67
Appendix 69

CITATIONS

Cases:

Aluminum Castings Co. v. Routzahn, 282 U.S. 92 54
American Automobile Assn. v. United States, 367 U.S. 687 ..... 8, *in passim*
Andrews v. Commissioner, 23 T.C. 1026 28
Automobile Club of Michigan v. Commissioner, 353 U.S. 180 ..... 28, 31, 33, 62
Automobile Club of New York v. Commissioner, 304 F. 2d 781, affirming 32 T.C. 906 ..... 27, 28, 41
Automobile Club of Southern California v. United States, 5 A.F.T.R. 2d 901, appeal dismissed, November 28, 1961 28
Bazley v. Commissioner, 331 U.S. 737 44
Beacon Publishing Co. v. Commissioner, 218 F. 2d 697, reversing 21 T.C. 610 ..... 28, 33, 34

Cases—Continued

	Page
Bratton v. Commissioner, 283 F. 2d 257, affirming 31 T.C. 891	16
Bressner Radio, Inc. v. Commissioner, 267 F. 2d 520, reversing 28 T.C. 378	28, 32, 40, 54
Brown v. Helvering, 291 U.S. 193	20, 25, 31, 40, 44, 45, 54
Burnet v. Sanford & Brooks Co., 282 U.S. 359	20, 21, 42, 52
Capital Warehouse Co. v. Commissioner, 171 F. 2d 395, affirming 9 T.C. 966	28, 30-31
Clay Sewer Pipe Ass'n. v. Commissioner, 139 F. 2d 130, affirming 1 T.C. 529	28, 31
Commissioner v. Fifth Avenue Coach Lines, 281 F. 2d 556, certiorari denied, 366 U.S. 964	40
Commissioner v. Hansen, 360 U.S. 446	16, 20, 44, 46
Continental Tie & Lumber Co. v. United States, 286 U.S. 290	56
Dixie Pine Co. v. Commissioner, 320 U.S. 516	20, 31, 54
General Gas Corp. v. Commissioner, 293 F. 2d 35, certiorari denied, 369 U.S. 816	16
Guaranty Trust Co. v. Commissioner, 303 U.S. 493	20, 25, 41, 54
Harrold v. Commissioner, 192 F. 2d 1002, reversing 16 T.C. 134	28
Healy v. Commissioner, 345 U.S. 278	27, 29, 38
Heiner v. Mellon, 304 U.S. 271	20
Helvering v. Union Pacific Co., 293 U.S. 282	55
Kansas City Southern Ry. Co. v. Commissioner, 52 F. 2d 372, certiorari denied, 284 U.S. 676	45
Kitrell v. United States, 79 F. 2d 259, certiorari denied, 296 U.S. 643	16
Levin v. Commissioner, 219 F. 2d 588	55
Lewyt Corp. v. Commissioner, 349 U.S. 237	20, 26
Libson Shops, Inc. v. Koehler, 353 U.S. 382	26
Lucas v. American Code Co., 280 U.S. 445	25, 37, 44, 54
Lucas v. Ox Fibre Brush Co., 281 U.S. 115	54
Mine Hill & Schuylkill Haven R. Co. v. Smith, 184 F. 2d 422, certiorari denied, 340 U.S. 932	45
New Capital Hotel v. Commissioner, 261 F. 2d 437, affirming *per curiam* 28 T.C. 706	28
New Jersey Automobile Club v. United States, 181 F. Supp. 259, certiorari denied, 366 U.S. 964	28
North American Oil v. Burnet, 286 U.S. 417	29

Cases—Continued Page
Old Colony R. Co. v. *Commissioner*, 284 U.S. 552 45
Pacific Grape Prod. Co. v. *Commissioner*, 219 F. 2d 862, reversing 17 T.C. 1097 28
Pinellas Ice Co. v. *Commissioner*, 287 U.S. 462 16
Pioneer Automobile Service Co. v. *Commissioner*, 36 B.T.A. 213 28
Rutkin v. *United States*, 343 U.S. 130 39
Sandegren v. *Commissioner*, decided January 30, 1962, appeal pending (C.A. 9th) 28
Schuessler v. *Commissioner*, 230 F. 2d 722, reversing 24 T.C. 247 ..... 28, 33, 34
Security Mills Co. v. *Commissioner*, 321 U.S. 281 ..... 20, 21, 23, 29, 31, 36, 38, 39, 42, 44, 54, 55
Shapiro v. *Commissioner*, 295 F. 2d 306, certiorari denied, 369 U.S. 829 16
South Dade Farms v. *Commissioner*, 138 F. 2d 818, affirming decision of September 21, 1942 ..... 28, 30, 41
Spencer, White & Prentis v. *Commissioner*, 144 F. 2d 45, affirming decision of June 21, 1943, certiorari denied, 323 U.S. 780 ..... 27, 30, 38, 40, 41, 53, 54
Spring City Co. v. *Commissioner*, 292 U.S. 182 ..... 20, 23, 24, 45, 56
Streight Radio and Television, Inc. v. *Commissioner*, 33 T.C. 127 ..... 41, 53
Streight Radio and Television, Inc. v. *Commissioner*, 280 F. 2d 883, affirming 33 T.C. 127, certiorari denied, 366 U.S. 965 ..... 28, 30, 40, 41, 53
United States v. *Anderson*, 269 U.S. 422 ..... 11, 20, 31, 52, 53, 55
United States v. *Consolidated Edison Co.*, 366 U.S. 380 ..... 20, 27, 54
United States v. *Lewis*, 340 U.S. 590 ..... 27, 29
Weiss v. *Wiener*, 279 U.S. 333 45
Your Health Club, Inc. v. *Commissioner*, 4 T.C. 385 28

Statutes:
Act of July 26, 1961, Section 1, 75 Stat. 222 59
Internal Revenue Code of 1939 (26 U.S.C., 1952 ed.):
Sec. 11 ..... 18, 40
Sec. 12 40
Sec. 13 18
Sec. 21 ..... 18, 40, 69
Sec. 21(a) 2, 18, 69

Statutes—Continued

Internal Revenue Code of 1939—Continued

	Page
Sec. 22	69
Sec. 22(a)	2, 18, 69
Sec. 23	69
Sec. 23(a)	18, 25, 69
Sec. 23(e)	2, 19, 25, 70
Sec. 23(k)	57
Sec. 41	2, 19, 20, 40, 70
Sec. 42	20, 70
Sec. 42(a)	2, 19, 71
Sec. 43	2, 19, 20, 71
Sec. 44	57
Sec. 48	19, 71
Sec. 48(a)	2, 71
Sec. 48(c)	2, 71
Sec. 115	41
Sec. 122	57
Secs. 181–188	2
Sec. 188	18
Sec. 201(c)	57
Sec. 202	57
Sec. 204(b)	57
Sec. 204(c)	57

Internal Revenue Code of 1954 (26 U.S.C., 1958 ed.):

Sec. 61	2, 19, 40, 72
Sec. 63	19, 40, 72
Sec. 63(a)	2, 72
Secs. 161–175	41
Sec. 162	19, 73
Sec. 162(a)	2, 73
Sec. 165	73
Sec. 165(a)	2, 73
Sec. 165(b)	2, 73
Sec. 165(c)	2, 74
Sec. 166	57
Sec. 171	57
Sec. 172	57
Secs. 241–247	41
Sec. 316	41
Sec. 441	19, 41, 74
Sec. 441(a)	2, 74

Statutes—Continued

Internal Revenue Code of 1954—Continued Page

Sec. 441(b) 2, 74
Sec. 441(c) 2, 74
Sec. 441(d) 2, 74
Sec. 441(e) 2, 74
Sec. 446 .... 2, 19, 41, 75
Sec. 451 .... 19, 76
Sec. 451(a) 2, 76
Sec. 452 .... 12, 26, 32, 56, 57, 58, 59, 62
Sec. 453 57
Sec. 455 .... 12, 56, 59, 61, 62
Sec. 456 .... 12, 56, 59, 61, 62
Sec. 461 .... 19, 76
Sec. 461(a) 2, 76
Sec. 461(c) 56
Sec. 462 .... 12, 26, 56, 62
Secs. 701-706 2
Sec. 706 18
Sec. 802 57
Sec. 803(b) 57
Sec. 804(a) 57
Sec. 832(b) 57
Sec. 832(c) 57
Sec. 1301-1304 57

Revenue Act of 1916, c. 463, 39 Stat. 756, Sec. 13(d) 52

California Civil Code, Title 2. 5, Secs. 1812.80-1812.95, added by Stat. 1961, c. 1675, § 1 66

Miscellaneous:

Accounting Research Bulletin No. 43, American Institute of Accountants, p. 59 (1953) 48

Accounting Terminology Bulletin No. 2, American Institute of Accountants, pp. 3-4 (March, 1955) 47

Costelloe, "Con Edison and AAA cases seen as landmarks in the law of tax accounting," 15 J. Taxation 216 (October 1961) 35

Eaton, "Financial Reporting in a Changing Society," 104 Journal of Accountancy 24 (August 1957) 48, 49

H.R. 8688, 86th Cong 59
H.R. 2440, 87th Cong 59
H.R. 2245, 87th Cong 59

Miscellaneous—Continued

	Page
H. Rep. No. 293, 84th Cong., 1st Sess., p. 4 (1955-2 Cum. Bull. 852, 854-855)	26
H. Rep. No. 381, 87th Cong., 1st Sess. (1961-2 Cum. Bull. 390)	59
Knauth, "An Executive Looks at Accountancy," 103 Journal of Accountancy 29 (January 1957)	49
Rev. Rul. 60-85, 1960-1 Cum. Bull. 181	40, 51
S. Rep. No. 1622, 83rd Cong., 2d Sess., p. 301 (3 U.S.C. Cong. and Adm. News (1954) 4621, 4940)	35, 58
Schapiro, "Tax Accounting for Prepaid Income and Reserves for Future Expenses," Tax Revision Compendium, Vol. 2, pp. 1133, 1142-1145	43
Spacek, "Can We Define Generally Accepted Accounting Principles," 106 Journal of Accountancy 40 (December 1958)	49
T.D. 2433, 19 Treasury Decisions, Internal Revenue 5 (1917)	52, 53
Treasury Regulations 118 (1939 Code):	
Sec. 39.22(a)-4	16
Sec. 39.41-1	3, 19, 76
Sec. 39.41-2	3, 19, 77
Sec. 39.41-3	3, 19, 79
Sec. 39.41-4	3, 19, 80
Sec. 39.42-1	3, 81
Sec. 39.42-4	3, 19, 51, 84
Sec. 39.43-1	3, 19, 82
Sec. 39.43-2	3, 19, 83
Treasury Regulations on Income Taxes (1954 Code):	
Sec. 1.61-2(d)	16
Sec. 1.441-1	3, 19, 83
Sec. 1.446-1	3, 19, 43, 50, 85
Sec. 1.451-1	3, 19, 50, 93
Sec. 1.451-3	3, 51, 95-96
Sec. 1.461-1	3, 19, 50, 96
Wienshienk, "Accountants and the Law," 96 U. Pa. Law Rev. 48 (1947)	49

In the Supreme Court of the United States

OCTOBER TERM, 1962

No. 80

MARK E. SCHLUDE, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT

PRIOR OPINIONS

The findings of fact and opinion of the Tax Court (R. 246–264) are reported at 32 T.C. 1271. The first opinion of the court of appeals (R. 278–291) is reported at 283 F. 2d 234. The *per curiam* order of this Court granting certiorari and remanding the case is reported at 367 U.S. 911. The order of this Court denying rehearing and amending the previous *per curiam* order is reported at 368 U.S. 873. The *per curiam* opinion of the court of appeals upon remand (R. 273–274) is reported at 296 F. 2d 721.

JURISDICTION

The judgment of the court of appeals was entered on December 15, 1961. (R. 274–275.) The petition

for a writ of certiorari, filed on March 15, 1962, was granted on May 28, 1962. The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the courts below correctly sustained the Commissioner's determination that an accrual basis taxpayer who contracts to furnish dancing lessons during a period extending beyond the close of the taxable year is required to accrue and report as gross income for the taxable year (a) cash and negotiable notes received in that year as an advance payment of the contract price, and (b) future installments contractually due in that year whether or not the "related" lessons have been taken.[1]

STATUTES AND REGULATIONS INVOLVED

The statutes involved are Sections 21(a), 22(a), 23(a)(1)(A), 23(e), 41, 42(a), 43, and 48(a) and (c), Internal Revenue Code of 1939; Sections 61, 63(a), 162(a), 165(a) through (c), 441(a) through (e), 446, 451(a), and 461(a), Internal Revenue Code of 1954. See Appendix, *infra*, pp. 69-76.

---

[1] The petitioners, husband wife, are members of a partnership which operates a dance studio. Though a partnership is not a separate taxable entity, the partners being liable for income tax in their individual capacities (see 1939 Code, Sections 181-188; 1954 Code, Sections 701-706), for convenience, the petitioners are sometimes referred to in the singular as "the taxpayer" or "the Studio."

Three "taxable years" of the Studio (fiscal years 1952-1954) are involved, and, for convenience, reference is sometimes made to a single taxable year. Numerous individual contracts are also involved, and they are also sometimes referred to in the singular.

The Regulations involved are Treasury Regulations 118 (1939 Code), Sections 39.41-1, 39.41-2, 39.41-3, 39.41-4, 39.42-1(a), 39.42-4, 39.43-1(a), and 39.43-2; Treasury Regulations on Income Taxes (1954 Code), Sections 1.441-1, 1.446-1, 1.451-1(a), 1.451-3, and 1.461-1(a). See Appendix, *infra*, pp. 76-99.

STATEMENT

The taxpayers, husband and wife, formed a partnership in 1946 known as Arthur Murray Dance Studio (the "Studio"), for the purpose of giving dance instruction and operating studios under franchise agreements received from Arthur Murray, Inc., of New York City. The partnership operated studios in the States of Nebraska, Iowa and South Dakota. (R. 248-249.)

Basically, there were two kinds of contracts entered into between the Studio and students. Under one type, all of the down payment was made in cash at the time the contract was executed, with the balance of the contract price to be paid in installments. Under the other, a portion of the down payment was paid in cash at the time the contract was entered into, and the balance was to be paid in installments; the remainder of the contract price was evidenced by a negotiable note taken from the student, which was payable in designated installments. (R. 249-250.)

All the contracts provided that (1) the student would pay for lessons in a certain amount, (2) the student should not be relieved of his obligation to pay the agreed amount, (3) no refunds would be made,

and (4) the contract was noncancellable. They further provided for a specific number of hours of lessons ranging from 5 to 1,200, and some of the contracts were for lifetime courses under which, in addition to 1,200 specified hours, the student was entitled to two hours of lessons per month plus two parties a year for life. Although the contracts specified a period during which the lessons had to be taken, they did not schedule specific dates for the lessons, these being arranged from time to time as lessons were given. Under many of the contracts the period of instruction extended beyond the fiscal year in which the contract was made, but in such cases the period usually ended in the next fiscal year. (R. 250.)

Notes accompanying contracts were negotiated by the Studio with a local bank. The bank would deduct its interest charges, pay approximately 50 per cent of the balance of the note to the Studio, and set up a reserve account for the other 50 per cent which the Studio could not use until after the note was paid in full by the student. When the note was paid, the balance in the reserve account was transferred to the Studio's general bank account. (R. 250–251.)

Cash payments received directly from students, the amounts received at the time notes were transferred to the bank, and the amounts received when notes transferred to the bank were fully paid, were either deposited or credited to the Studio's general bank account without segregation from its other partnership funds. (R. 251.)

Although the contracts stated that they were noncancellable, some of them were in fact cancelled, ac-

counting for about 17% of the taxpayer's total sales (R. 256, 258), and the Studio frequently rewrote contracts to reduce the number of lessons and the total charge. Also, despite the fact that the contracts provided that no refund would be made, and despite the fact that the Studio discouraged refunds, occasionally a refund would be made on a canceled contract. (R. 251.)

When the partnership was organized in 1946, a complete double entry bookkeeping system was installed by a firm of certified public accountants, and an accrual system of accounting, with a fiscal year ending March 31, was employed. This accounting system was used continuously and consistently from the time the partnership was formed. Additionally, individual student record cards were maintained, listing all pertinent information such as name and address of student, type of contract, hours involved, total contract price, history of lessons taught, and payments made under the contract. (R. 251–252.)

The accounting method used by the Studio is shown in detail in the findings of the Tax Court. In substance, when a contract was entered into with a student, a "deferred income" account was credited with the total contract price. At the close of each fiscal year, the student record cards were analyzed and the number of hours of lessons taught multiplied by the contract rate per hour was then deducted from "deferred income" and credited to "earned income." The so-called "earned income" thus derived was reported as gross income on the Studio's tax return. (R. 252–253.)

Expenses were recorded and deducted in the fiscal year incurred except that royalties to Arthur Murray, Inc., and certain other items[2] were recorded and deducted when paid (R. 252).

Additional gross income was reported by the Studio each year as "gains from cancellation" of contracts. The Studio would treat as canceled any contract which had been inactive for more than a year. Gain on a cancelled contract would be computed as the amount by which the "deferred income" account with respect to such contract exceeded the unpaid portion of the contract price, i.e. the amount received in advance for untaught lessons. (R. 253.)[3]

Schedules reflecting the Studio's system of accounting during the years in question (R. 253-256) show, *inter alia*, that the ending balances in its "deferred income" account were $131,143.92, $235,942.33, and $248,740.30 for the fiscal years 1952, 1953, and 1954, respectively (R. 254). Of these ending balances, the aggregate amounts and percentages attributable to cash in hand,[4] plus funds held in the reserve account

[2] E.g., commissions to personnel for selling lessons (R. 218-219). Refunds were not recorded or claimed as separate items of deduction, but were charged to "deferred income", thereby reducing the "gains" ultimately reported from contract cancellations. (R. 220-221.)

[3] The Studio did not report any losses from cancellation during the years in question. (R. 256.)

[4] Denoted as "Deferred Income Collected." (R. 255.)

[5] Denoted as "Reserve Fund Held by Bank on Students Notes Financed." (R. 255.) On the original exhibit, from which the schedule was drawn, there were alternative computations the first of which treated the "Reserve Fund" separately, and the second of which treated it as part of "Deferred Income Collected." (Ex. 14-N; R. 145, 218-219.)

were \$67,516.69, or 52 per cent, for fiscal 1952; \$149,244, or 63 per cent, for fiscal 1953; and \$163,563.20, or 66 per cent, for fiscal 1954.[6] (R. 255.) The remainder of the annual ending balance in the "deferred income" account was attributable to "Students Accounts Receivable" of \$63,627.23, or 48 per cent, for fiscal 1952; \$86,698.33, or 37 per cent, for fiscal 1953; and \$85,177.10, or 34 per cent for fiscal 1954. (R. 255.) "Students Accounts Receivable" was in turn comprised of "Installment Contracts Carried by Studio, Notes Not Yet Processed Through the Bank, and Unpaid Balances on Planned Cash Courses." (R. 255.)[7]

The ordinary net income of the Studio, as reflected on its books and returns for the years in question, was computed in the following manner (R. 256):

	March 31, 1952	March 31, 1953	March 31, 1954
Gross Income			
Contract Amts. transferred to Earned Income	[illegible]	[illegible]	[illegible]
Gains from cancellation	[illegible]	[illegible]	[illegible]
Other Income	[illegible]	[illegible]	[illegible]
Total	[illegible]	[illegible]	[illegible]
Deductions	[illegible]	[illegible]	[illegible]
Ordinary Net Income	[illegible]	[illegible]	[illegible]

[6] A typical computation is as follows: For fiscal 1954, the sum of the ending balances of "Deferred Income Collected" (\$129,029.98) and "Reserve Fund" (\$34,533.22) is \$163,563.20. (R. 255.) This total is approximately 66 percent of the ending balance in the "deferred income" account (\$248,740.30). (R. 254.)

[7] The record does not contain an arithmetical or percentage breakdown of the subsidiary items comprising "Students Accounts Receivable," nor does it show precisely how much of the overall ending balance in the "deferred income" account for each year derived from contracts entered into in that year as opposed to contracts entered into in a previous year (or years).

As appears from the above table, a substantial part of the "Ordinary Net Income" reported by the Studio in each year consisted of "gains from cancellation" rather than "Earned Income".

The Commissioner ruled that the Studio was required to report the entire amount of each contract as gross income for the year in which the contract was entered into. Accordingly, in his notices of deficiency he increased the ordinary net income of the partnership for each fiscal year by the amount of the increase in the "deferred income" account in that year, viz., $24,602.22 for 1952, $104,798.41 for 1953, and $12,797.97 for 1954. (R. 256.) The Tax Court, three judges dissenting, sustained the Commissioner's determination. (R. 246-264.) The court of appeals, one judge dissenting, reversed the Tax Court. (R. 278-291.)

The Commissioner's petition for certiorari to review the court of appeals' decision was pending when this Court decided *American Automobile Assn.* v. *United States*, 367 U.S. 687. On the same day, the Court granted certiorari, vacated the judgment, and remanded the case to the court of appeals for reconsideration in the light of that decision. 367 U.S. 911; 368 U.S. 873. Upon reconsideration, after re-argument, the court of appeals vacated its prior judgment and affirmed the decision of the Tax Court. (R. 273-274.)

SUMMARY OF ARGUMENT

I. THE ADVANCE RECEIPTS

A. Deeply rooted in our taxing system is the axiom that the statutory "net income"—the difference be-

tween the total amount of "gross income" items and the total amount of "deduction" items—must be computed and reported on an annual ("taxable year") basis, regardless of whether a particular contract or transaction which gives rise to the items of gross income and deduction spans more than one taxable year or ultimately produces a net profit or loss. As applied to a taxpayer reporting taxable income under the "accrual" method of accounting, as distinguished from the "cash" method, the annual accounting rule requires that an item of gross income (*e.g.*, compensation for services, gain from a sale, *etc.*) be reported in the taxable year when the right to receive it becomes fixed (irrespective of when it is receivable), which can be no later than the year in which the income is actually received under claim of right and without restriction as to its use. Conversely, an item of deduction (*e.g.*, expense, loss, etc.) may be offset against gross income only in the taxable year in which the taxpayer's liability to pay it becomes fixed (irrespective of when it is payable), which can be no later than the year in which it is actually paid without protest.

This Court has repeatedly held that a taxpayer who receives money under a claim of right and without restriction as to its disposition must report it as gross income in the year received—whether he employs the cash or the accrual method of accounting—even though he may become obliged to and does refund the income in a later year. Since an obligation to restore the very income received does not relieve the recipient of the duty to report the income in the year of receipt, an obligation to incur future expenses in consideration

of the income received surely does not suffice to do so. Only if and when the expenses of performance are *actually incurred—i.e.*, only in the taxable year when the liability to pay becomes fixed in fact and amount—will an accrual basis taxpayer become entitled to deduct them.

In so far as the advance receipts are concerned, the situation here is in all material respects the same as in *American Automobile Assn. v. United States*, 367 U.S. 687, which holds that compensation paid in advance for future services must be reported in the taxable year of receipt and may not be deferred until a later year in which the services are to be performed.

2. The Studio's accounting system violates the annual accounting rule and related accrual principles. By attempting to "match" against compensation currently received for future services "related costs" of future performance, the Studio in effect is seeking, in the guise of deferral of "unearned income", to reduce its actual gross income by a reserve for estimated future expenses—an accounting procedure specifically disapproved by this Court. The Studio ought not be permitted to accomplish indirectly, by way of exclusion from gross income, what it cannot do directly by way of deduction. Essentially the same "earned" income argument here advanced by the Studio and amicus was rejected by this Court in the A.A.A case.

We have no quarrel with the Studio's contention (reiterated by the amicus curiae) that its system of accounting was in conformity with generally accepted commercial accounting practices. However, as this

Court has often held, commercial accounting methods are not determinative of proper accounting for federal income tax purposes. Accounting practices designed to reflect net income in reports to stockholders or creditors are not necessarily suited to the requirements of a tax system, and the meaning accorded "net income" by the accounting profession differs from its meaning as used in the Internal Revenue Code and consistently applied by this Court.

Far from supporting its contention, the cases upon which the Studio chiefly relies (*e.g.*, *United States* v. *Anderson*, 269 U.S. 422) support the decision below. They involved deduction items, and they hold that such items are deductible by an accrual basis taxpayer only in the taxable year in which all the events which fix the liability to pay have occurred—the so-called "all events" test. The "related costs" which the Studio is here attempting indirectly to deduct are expenses not yet incurred. As for the cases involving accrual of income upon which the Studio relies (*e.g.*, *Spring City Co.* v. *Commissioner*, 292 U.S. 182), they likewise support the Government's position. They stand for the proposition that gross income must be reported in the taxable year in which the taxpayer's right to receive it becomes fixed, and the opinions are to be searched in vain for any suggestion that one who receives advance payment for future services has no "right to receive" the amounts when received.

Finally, in harmony with the controlling decisions, the Regulations also embody the fixed "right to re-

ceive" test for the accrual of gross income items (and the correlative fixed "liability to pay" test for accrual of deduction items), and the Commissioner has expressly ruled that prepaid service income received under a claim of right and without restriction as to its use must be reported in its entirety in the year of receipt.

B. As this Court pointed out in *American Automobile Assn.* as an independent ground for its decision (367 U.S. at 694-697), Congress has evinced an unmistakable intention to endorse the long-standing view of the Commissioner and the courts precluding deferral of income received in one taxable year for services to be performed in a later year. This is demonstrated by the legislative history surrounding the enactment and repeal of 1954 Code, Sections 452 and 462, dealing respectively with deferral of prepaid income and deductions of reserves for estimated expenses. And it is confirmed by the history of recent legislation (1954 Code, Sections 455 and 456) authorizing, with carefully specified safeguards and limitations, only designated classes of taxpayers (publishers of periodicals and certain membership corporations) to defer prepaid income. These indications, together with the unsuccessful career of several bills designed to permit income-deferral by other classes of taxpayers, show that Congress is aware of the problem which this case presents and has it under continuing study. In *American Automobile Assn.* the Court expressly refrained from carving out exceptions to the annual accounting rule and corollary accrual principles which Congress itself

has not seen fit to create—a course made particularly desirable by "the complications inherent in the problem and its seriousness to the general revenue" (367 U.S. at 697). The same considerations, we submit, counsel a similar course here.

C. In any event, the accounting system used by the Studio is artificial, and must, for that reason, be rejected.

II. THE FUTURE INSTALLMENTS

With respect to the unreceived portion of the contract price—the future installments—we acknowledge that it was error for the Commissioner to treat the entire amount as having accrued at the time the contract was executed. The "right to receive" a future installment became fixed on either of the following dates, whichever arrived earlier: (1) when the services for which the installment was payable were rendered, or (2) when the installment payment became due under the contract. The case should be remanded for a determination, under this test, of how much of the unreceived portion of the contract price accrued within each taxable year.

ARGUMENT

INTRODUCTION

The taxpayers, members of a partnership operating a dance studio, entered into contracts with students to furnish a specified number of dancing lessons on dates to be arranged by the student. Part of the contract price was paid in cash (or negotiable notes) at the time the contract was executed, and the balance was payable in installments on fixed dates which bore no

relationship to the dates lessons were to be given. Under the terms of the contract the Studio had a right to receive, and did in fact receive, most of the contract price in advance of furnishing lessons.[8] In many instances, the Studio was never called upon to furnish all the lessons contracted for, and after a waiting period it cancelled the contract without refunding the advance payment. The Studio prorated the contract price according to the number of lessons to be furnished under the contract, and in its federal income tax returns (filed on the fiscal year-accrual basis) it reported as gross income for the taxable year only the portion it attributed to lessons given during that year. It treated the balance as "deferred" or "unearned" income, reportable in a subsequent taxable year in which the remaining lessons were to be given or in which the contract was cancelled.[9] Both courts below agreed

---

[8] The record does not contain a contract by contract breakdown of receipts *vis-a-vis* accounts receivable. However, as pointed out in the Statement (*supra*, pp. 6-7), approximately 50 to 60 per cent of the annual ending balance in the Studio's "deferred income" account for each fiscal year represented amounts actually received in cash and negotiable notes on contracts entered into during the year, and the remaining 40 to 50 per cent represented accounts receivable due in the following year (or years). We assume, in the absence of any contrary proof by taxpayer, that these overall percentages are an accurate reflection of the percentages applicable to each individual contract.

[9] The Studio's method of accounting may be illustrated by the following example given by the Tax Court (R. 257):

> On August 1, 1952, the Studio enters into a contract with a student whereby the Studio agrees to teach the student 24 1-hour dancing lessons and the student agrees to pay $240 therefor, $100 down and $20 per month for the next 7 months. (In some cases the student gives a negotiable

with the Commissioner that the Studio's method of accounting did not clearly reflect its annual taxable income, and that the Studio was required to report the full contract price as gross income for the taxable year in which the contract was executed.

The tax accounting problem presented divides itself into two parts: (1) includability in the Studio's gross income for the taxable year of the portion of the contract price received in that year in cash or negotiable notes pursuant to the terms of the contract,[10]

note for the installment payments.) Lessons are arranged from time to time and at the end of 1952 the Studio has given the student 10 lessons and the student has paid $180, the $100 down and four $20 installments. By March, 1953, the Studio gives the student 10 additional lessons and the student pays $40, two more installments. The student loses interest in the course and does not take the remaining four lessons and the Studio is unable to collect the remaining $20.

In 1952 the Studio, which reports on an accrual basis, returns as gross income $100, representing 10 lessons taught at $10 per lesson. During 1953 the Studio returns as gross income $100 representing 10 lessons taught at $10 per lesson. After the contract has been inactive for a year the Studio cancels it, computing a gain or loss thereon. Here the gain would be $20. (Four lessons untaught at $10 per lesson equals $40, less contract price unpaid of $20 equals $20 gain). This $20 gain on cancellation would be returned as gross income in 1954.

[10] In many instances, the Studio received (in addition to cash) negotiable notes, which it negotiated with a bank. After deducting interest charges the bank paid approximately 50 per cent of the amount of the note to the Studio, and credited the other 50 per cent to a reserve account which was transferred to the Studio's general bank account when the note was paid by the student. (R. 250-251.) The 50 per cent received by the Studio in cash from the bank manifestly falls in the same category as the cash received by it directly from students.

for lessons to be furnished after the close of the year (Point I, *infra*); (2) includability of the balance of the contract price receivable in future installments (Point II, *infra*).

With respect to the advance receipts, the issue here is essentially the same as in *American Automobile Assn. v. United States*, 367 U.S. 687, rehearing denied, 368 U.S. 890, namely, whether an accrual basis taxpayer may postpone the reporting of compensation received in one taxable year for services to be rendered in a later year, so as to "match" and offset

---

As for the other 50 per cent credited to the Studio by the bank in the reserve account, since the Studio had a fixed right to receive the amount credited when the note was paid by the student, subject only to its contingent liability as guarantor, for tax accounting purposes this amount likewise falls in the same category as the cash receipts. See *Commissioner v. Hansen*, 360 U.S. 446; *General Gas Corp. v. Commissioner*, 293 F. 2d 35 (C.A. 5th), certiorari denied, 369 U.S. 816; *Shapiro v. Commissioner*, 295 F. 2d 306 (C.A. 9th), certiorari denied, 369 U.S. 829. The reserve account is indistinguishable from the cash receipts for present purposes for the additional reason that there has been no showing that the fair market value of the notes when received was less than the total amount (cash paid plus reserve credited) at which they were discounted by the bank. See Section 39.22(a)-4 of Regulations 118 under the 1939 Code; Section 1.61-2(d)(1) and (4) of the Regulations under the 1954 Code; *Bratton v. Commissioner*, 283 F. 2d 257 (C.A. 6th), affirming 31 T.C. 891; *Kitrell v. United States*, 79 F. 2d 259, 262 (C.A. 10th), certiorari denied, 296 U.S. 643; cf. *Pinellas Ice Co. v. Commissioner*, 287 U.S. 462, 468-469. At any rate, neither the Studio nor the amicus raises any separate question as to the treatment of the notes for purposes of this case, and we suggest the Court may treat them on the same footing as the cash receipts, without resolving the question.

against the amount received "related" service expenses which the taxpayer expects to incur in the later year. It is the Commissioner's position (1) that *any* method of accounting which defers the reporting of compensation actually received in one taxable year constitutes a clear departure from the annual accounting rule and corollary accrual principles consistently applied by this Court in federal income tax cases; (2) alternatively, even assuming (as the Studio and amicus curiae contend) that the *AAA* decision is to be construed as sanctioning the use for federal income tax purposes of a deferral-of-prepaid-income method of accounting which is not "artificial", nevertheless the particular method which the Studio here employed is artificial and, accordingly, was properly rejected.

With respect to the balance of the contract price receivable in future installments, we agree with the Studio that it was not required to accrue the installments at the time the contract was executed, as originally determined by the Commissioner. In our view, the Studio acquired a fixed right to receive the installment payments when it furnished the lessons for which the installments were payable, or when the stipulated time for payment of the installment arrived, whichever date was earlier. Accordingly, we consent to a remand of the case for the purpose of allocating the correct portion of the deferred contract price, on this basis, to each of the taxable years involved.

I. THE ADVANCE RECEIPTS

THE STUDIO'S METHOD OF ACCOUNTING, DEFERRING THE ACCRUAL AND REPORTING OF COMPENSATION RECEIVED IN THE TAXABLE YEAR IN ORDER TO REFLECT RELATED SERVICE EXPENSES TO BE INCURRED IN A LATER YEAR, WAS PROPERLY REJECTED BY THE COMMISSIONER AND BOTH COURTS BELOW AS VIOLATING SETTLED TAX ACCOUNTING PRINCIPLES

A. *The Studio's transactional method of accounting does not reflect its taxable net income for each taxable year*

1. Under the annual accounting rule and related accrual principles gross income items must be reported in the taxable year in which the right to receive them becomes fixed, and deduction items in the year in which the liability to pay them becomes fixed

Sections 11 and 13 of the Internal Revenue Code of 1939 impose a tax on the "net income" of individuals and corporations, respectively.[11] Section 21 (Appendix, *infra*, p. 69) defines "net income" as the "gross income" less allowable "deductions". Section 22(a) (Appendix, *infra*, p. 69) defines gross income as including compensation for services, and Sections 23 (a)

[11] The deficiencies in controversy are for the calendar years 1952, 1953 and 1954, i.e., the taxable years of the individual partners. The taxable years of the partnership, used for information purposes only, are the fiscal years ended March 31, 1952, March 31, 1953, and March 31, 1954. Where the taxable year of a partner is different from that of the partnership, the partner includes in his annual return the share of partnership net income attributable to him for the taxable year of the partnership ending within his own taxable year. Section 188, Internal Revenue Code of 1939, Section 706, Internal Revenue Code of 1954. With respect to the first two of the three years involved, the 1939 Code and Treasury Regulations 118 apply. The comparable provisions of the 1954 Code and implementing Treasury Regulations, which apply to the third year, are substantially the same in all material respects, although more explicit.

and (e) (Appendix, *infra*, pp. 69–70) respectively authorize the deduction of ordinary and necessary business expenses "paid or incurred during the taxable year" and "losses sustained during the taxable year." Sections 41, 42(a), and 43 (Appendix, *infra*, pp. 70–71) require net income to be computed and reported upon the basis of an "annual accounting period" (the "taxable year"), in accordance with the method of accounting regularly employed by the taxpayer, provided such method clearly reflects the net income for the taxable year." See also section 48 (Appendix, *infra*, p. 71); Sections 39.41-1, 39.41-2, 39.41-3, 39.41-4, 39.42-4, 39.43-1, 39.43-2 of Regulations 118 under the 1939 Code (Appendix, *infra*, pp. 76–83).[12]

For federal income tax purposes, as this Court has frequently noted, the two principal recognized accounting systems are the "cash" and "accrual" methods. Under the cash method, gross income is reported in the taxable year of actual receipt and deductions are taken in the year of actual expenditure. Under the accrual method, gross income items are reported in the year in which the right to receive them becomes fixed, even though they are not immediately receivable, but no later than the year of actual receipt; conversely, deduction items are reported in the year in which they are incurred, i.e., when the liability to pay becomes fixed in fact and

---

[12] The comparable provisions of the 1954 Code are Sections 61, 63, 162, 441, 446, 451, and 461 (Appendix, *infra*, pp. 72–76), and the comparable provisions of the Treasury Regulations under the 1954 Code are Sections 1.441-1, 1.446-1, 1.451-1, 1.461-1 (Appendix, *infra*, pp. 83–99).

reasonably ascertainable in amount, even though payment is not then due, but no later than the year of actual payment. Whichever method is adopted must of course be applied consistently. *Security Mills Co. v. Commissioner,* 321 U.S. 281; *Spring City Co. v. Commissioner,* 292 U.S. 182; *Commissioner v. Hansen,* 360 U.S. 446; *American Automobile Assn. v. United States,* 367 U.S. 687; *Brown v. Helvering,* 291 U.S. 193; *United States v. Anderson,* 269 U.S. 422; Dixie *Pine Co. v. Commissioner,* 320 U.S. 516.[13]

The cardinal rule, embodied in 1939 Code Sections 41–43 and repeatedly affirmed by this Court, is that taxable net income must be computed on an annual ("taxable year") basis, whether the cash or the accrual method is selected. Neither income nor deduction items may be accelerated or postponed from one taxable year to another in order to reflect the long-term economic result of a particular transaction or group of transactions. *Security Mills Co. v. Commissioner, supra; Spring City Co. v. Commissioner, supra; Dixie Pine Co. v. Commissioner, supra; Burnet v. Sanford & Brooks Co.,* 282 U.S. 359; *Guaranty Trust Co. v. Commissioner,* 303 U.S. 493; *Heiner v. Mellon,* 304 U.S. 271; *Lewyt Corp v. Commissioner,*

[13] Cf. *United States v. Consolidated Edison Co.,* 366 U.S. 380, reaffirming these general principles, but holding—on "the very narrow issue" involved (p. 387)—that the remittance of real estate taxes under protest, in accordance with the only method provided by state law for contesting their validity without risk of penalties or seizure and sale of the property, did not constitute a "payment" sufficient to require accrual of the taxes as a deduction in a year prior to the year in which the contest was finally resolved.

349 U.S. 237. As this Court said in *Security Mills, supra* (pp. 286–287):

> The rationale of the system is this: "It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals. Only by such a system is it practicable to produce a regular flow of income and apply methods of accounting, assessment, and collection capable of practical operation." [Quoting from *Burnet* v. *Sanford & Brooks Co.*, 282 U.S. at 363.][11]

---

[11] In *Sanford & Brooks* the Court rejected the taxpayer's contention that compensatory damages received in one year under a construction contract could be matched against expenses incurred in a prior year under the contract, in order to arrive at the taxable income. Holding that the amounts received were includible in gross income in the year of receipt, Mr. Justice Stone stated, 282 U.S. at 363–365:

> All the revenue acts which have been enacted since the adoption of the Sixteenth Amendment have uniformly assessed the tax on the basis of annual returns showing the net result of all the taxpayer's transactions during a fixed accounting period, either the calendar year, or, at the option of the taxpayer, the particular fiscal year which he may adopt. Under §§ 230, 232 and 234 (a) of the Revenue Act of 1918, 40 Stat. 1057, respondent was subject to tax upon its annual net income, arrived at by deducting from gross income for each taxable year all the ordinary and necessary expenses paid during that year in carrying on any trade or business, interest and taxes paid, and losses sustained, during the year. * * *
>
> * * * * *
>
> A taxpayer may be in receipt of net income in one year and not in another. The net result of the two years, if combined in a single taxable period, might still be a loss; but it has never been supposed that that fact would relieve him from a tax on the first, or that it affords any reason for postponing the assessment of the tax until the end of

This legal principle has often been stated and applied. The uniform result has been denial both to Government and to taxpayer of the privilege of allocating income or outgo to a year other than the year of actual receipt or payment, *or, applying the accrual basis, the year in which the right to receive, or the obligation to pay, has become final and definite in amount.*

But the petitioner urges that § 43 has altered the rule, so that a hybrid system, partly annual and partly transactional, may, within administrative discretion, be substituted for that of annual accounting periods. It urges that the change was due to the desire of Congress to prevent distortion of true income. This must mean distortion of true income, not of a given year, but, in the light of ultimate gain, from a series of transactions over a period of years, growing out of, or in some way related to, an initial transaction in the taxable year. The very section on which petitioner relies, however, reiterates the adherence of Congress to the system of annual periods of computation. [Emphasis added.]

---

a lifetime, or for some other indefinite period, to ascertain more precisely whether the final outcome of the period, or of a given transaction, will be a gain or a loss.

* * * * *

While, conceivably, a different system might be devised by which the tax could be assessed, wholly or in part, on the basis of the finally ascertained results of particular transactions, Congress is not required by the amendment to adopt such a system in preference to the more familiar method, even if it were practicable. It would not necessarily obviate the kind of inequalities of which respondent complains. * * *

* * * * *

The taxpayer in *Security Mills*, reporting on the accrual basis, had included in gross income for 1935 certain processing taxes which it had collected as part of the sales price of flour sold to customers. Concurrently, in order to reflect the fact that, though contesting the constitutionality of the tax, it had in fact paid the amounts collected into a depository in a suit to enjoin their payment over to the Government, the taxpayer claimed the taxes as a deduction from gross income. Applying the annual accounting rule and related accrual concepts, the Court sustained the Commissioner's disallowance of the deduction. The result undoubtedly would have been no different had the taxpayer, instead of reporting the amount in question as gross income and currently claiming it as a deduction, merely attempted (as does the taxpayer here) to exclude the amount from gross income by "deferring" its accrual.

In *Spring City Co.* v. *Commissioner*, 292 U.S. 182, a taxpayer filing its returns on the accrual basis sold goods on open account to a vendee which became insolvent during the taxable year of the sale. This Court held that the taxpayer could not defer reporting the account receivable as gross income in the year of sale in order to reflect the related bad debt loss resulting from the vendee's bankruptcy, since the "right to receive" the sale price from the vendee became "fixed" during the taxable year, whereas the related loss was not incurred and deductible until a later year. Mr. Chief Justice Hughes stated (pp. 184–185):

Petitioner first contends that the debt, to the extent that it was ascertained in 1920 to be worthless, was not returnable as gross income in that year, that is, apart from any question of deductions, it was not to be regarded as taxable income at all. We see no merit in this contention. Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis, import that it is the *right* to receive and not the actual receipt that determines the inclusion of the amount in gross income. When the right to receive an amount becomes fixed, the right accrues. * * * [Italics the Court.]

* * * * *

If such accounts receivable become uncollectible, in whole or part, the question is one of the deduction which may be taken according to the applicable statute. See *United States* v. *Anderson*, 269 U.S. 422, 440, 441; *American National Co.* v. *United States*, 274 U.S. 99, 102, 103; *Brown* v. *Helvering*, 291 U.S. 193, 199; *Rouss* v. *Bowers* 30 F. (2d) 628, 629. That is the question here. *It is not altered by the fact that the claim of loss relates to an item of gross income which had accrued in the same year.* [Emphasis added.]

The reasoning which led this Court in *Spring City* to hold that a "loss" which had not been actually incurred during the taxable year did not warrant postponement of accrual of a related item of gross income applies with equal force to related income and "expense" items. Here, as in *Spring City Co.*, the question "is one of the deduction which may be taken according to the applicable statute," and that question "is not altered by the fact that the claim of loss [here, expense] relates to an item of gross income which had

accrued in the same year." Treating the issue as one of deduction rather than as one affecting the accrual of gross income, it is clear that anticipated losses may not be deducted under Section 23(e) until they are in fact "sustained", and that similarly anticipated expenses may not be deducted under Section 23(a) until they are in fact "incurred." They may not be accounted for in advance by postponing the return of gross income items to which they "relate." See also *Guaranty Trust Co. v. Commissioner*, 303 U.S. 493; *Lucas v. American Code Co.*, 280 U.S. 445; *Brown v. Helvering*, 291 U.S. 193.

In *Brown v. Helvering*, *supra*, the Court held that a taxpayer filing his returns on the accrual basis was not entitled to deduct from gross income (insurance commissions) received in the taxable year an amount which his experience indicated would have to be refunded on account of policy cancellations, since his liability to repay was contingent, not fixed and absolute in that year. The Court stated (p. 199):

> Under the Revenue Acts taxable income is computed for annual periods. If the accounts are kept on the accrual basis the income is to be accounted for in the year in which it is realized even if not then actually received; and the deductions are to be taken in the year in which the deductible items are incurred. * * *

The Studio in effect is here attempting to accomplish what this Court in *Brown* held was not permissible—to offset against gross income for the taxable year an estimated amount of expense liabilities not yet incurred. While it seeks to exclude (?ithe-

fer") an estimated amount from gross income, instead of deducting it therefrom (as in *Brown*), the net result, from the tax standpoint, is the same under either method. As Congress recognized when it repealed Sections 452 (deferral of prepaid income) and 462 (accrual of estimated expenses) of the 1954 Code, "if section 452 is not repealed at the same time section 462 is repealed, a number of taxpayers who have reported a greatly reduced tax liability by electing the benefits of section 462 would be able to accomplish the same result by electing to defer income under section 452." H. Rep. No. 293, 84th Cong., 1st Sess., p. 4 (1955-2 Cum. Bull. 852, 854-855).[15]

Recent decisions of this Court have continued to sustain the application of the annual accounting rule to both accrual basis and cash-basis taxpayers despite its sometimes inequitable results.[16] Thus in *Lewyt Corp. v. Commissioner*, 349 U.S. 237, it was stated (p. 242) that "the concept 'accrued' embodies the an-

[15] Indeed, the impact upon the revenues of the deferral of gross income is even greater than the accrual of estimated expenses, since included in the gross income deferred is an element of profit which will be taxed, if at all, only in a later year when returned as "earned income" or "gains from cancellations." On the other hand, if future expenses are presently estimated and deducted, the profit element would at least be taxed in the year the income is received. Both methods, however, fail to satisfy the annual accounting requirement and may be rejected by the Commissioner.

[16] In *Libson Shops, Inc.* v. *Koehler*, 353 U.S. 382, 386, the Court observed that the special net operating loss carryover and carryback provisions of the statute (not applicable here) were enacted "to ameliorate the unduly drastic consequences of taxing income strictly on an annual basis * * * and to strike something like an average taxable income computed over a period longer than one year."

nual accounting principle," and that the settled meaning of that term would be effectively vitiated if an accrual basis taxpayer were permitted to take "events after the taxable year * * * into account." In *United States v. Consolidated Edison Co.*, 366 U.S. 380, 3[illegible]4, it was regarded as "settled that each 'taxable year' must be treated as a separate unit, and all items of gross income and deductions must be reflected in terms of their posture at the close of such year." In *United States v. Lewis*, 340 U.S. 590, the Court stated (p. 592) "Income taxes must be paid on income received (or accrued) during an annual accounting period." In *Healy v. Commissioner*, 345 U.S. 278, it reiterated (pp. 284–285): "Congress has enacted an annual accounting system under which income is counted up at the end of each year * * *. This basic principle cannot be changed simply because it is of advantage to a taxpayer or to the Government in a particular case that a different rule be followed." And in *American Automobile Assn. v. United States*, 367 U.S. 687, which we submit is dispositive of the instant case with respect to the advance receipts, the Court concluded (p. 692) that the taxpayer's system of accounting "fails to respect the criteria of annual tax accounting and may be rejected by the Commissioner."[17]

[17] In harmony with this Court's decisions, the clear weight of authority in the court of appeals, and the uniform authority in the Tax Court, has required adherence to the annual accounting rule in a variety of contexts. See, e.g., *Spencer, White & Prentis v. Commissioner*, 144 F. 2d 45 (C.A. 2d), affirming 1943 P-H T. C. Memorandum Decisions, par. 43,306, certiorari denied, 323 U.S. 780; *Automobile Club of New York v. Commissioner*, 304 F. 2d 781 (C.A. 2d), affirming 32 T.C.

It is settled, as a familiar corollary of the annual accounting rule, that a taxpayer (whether on the

906; *Streight Radio and Television, Inc.* v. *Commissioner*, 280 F. 2d 883 (C.A. 7th), affirming 33 T.C. 127, certiorari denied, 366 U.S. 965; *Capital Warehouse Co.* v. *Commissioner*, 171 F. 2d 395 (C.A. 8th), affirming 9 T.C. 966; *South Dade Farms* v. *Commissioner*, 138 F. 2d 818 (C.A. 5th), affirming 1942 P-H B.T.A. and T.C. Memorandum Decisions, par. 42,516; *Clay Sewer Pipe Ass'n* v. *Commissioner*, 139 F. 2d 130 (C.A. 3d), affirming 1 T.C. 529; *New Capital Hotel* v. *Commissioner*, 261 F. 2d 437 (C.A. 6th), affirming *per curiam* 28 T.C. 706; *New Jersey Automobile Club* v. *United States*, 181 F. Supp. 259 (C. Cls.), certiorari denied, 366 U.S. 964; *Automobile Club of Southern California* v. *United States*, 5 A.F.T.R. 2d 901 S.D. Cal. 1960), appeal dismissed (C.A. 9th) November 28, 1961; *Sandegren* v. *Commissioner*, decided January 30, 1962 (1962 P-H T.C. Memorandum Decisions, par. 62,016; appeal pending (C.A. 9th)); *Andrews* v. *Commissioner*, 23 T.C. 1026; *Your Health Club, Inc.* v. *Commissioner*, 4 T.C. 385; *Pioneer Automobile Service Co.* v. *Commissioner*, 36 B.T.A. 213.

The only cases of which we are aware that might be viewed as departures from the principles of annual tax accounting are *Beacon Publishing Co.* v. *Commissioner*, 218 F. 2d 697 (C.A. 10th), reversing 21 T.C. 610; *Schuessler* v. *Commissioner*, 230 F. 2d 722 (C.A. 5th), reversing 24 T.C. 247; and *Bressner Radio, Inc.* v. *Commissioner*, 267 F. 2d 520 (C.A. 2d), reversing 28 T.C. 378; cf., *Harrold* v. *Commissioner*, 192 F. 2d 1002 (C.A. 4th), reversing 16 T.C. 134; *Pacific Grape Prod. Co.* v. *Commissioner*, 219 F. 2d 862 (C.A. 9th), reversing 17 T.C. 1097. Of these, the *Bressner* case was effectively overruled, and the *Beacon Publishing Co.* and *Schuessler* cases were distinguished on their facts, in *American Automobile Assn.* v. *United States*, 367 U.S. 687, pp. 689, 691, note 4. We share the Tax Court's view (*Andrews* v. *Commissioner*, 23 T.C. 1026, 1033; *Automobile Club of New York* v. *Commissioner*, 32 T.C. 906, 912) that *Beacon Publishing Co.* and *Schuessler* were erroneously decided. This Court has expressly refrained from endorsing them as correct. See *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180, 189, note 20. In any event, as pointed out below, they are distinguishable from the present

case for the same reasons they were distinguished in *American Automobile Assn., supra*, p. 691, note 4.

cash or accrual basis) who receives income under a claim of right and without restriction as to its use must report it in the year received, even though he may later be required to restore the income. *North American Oil* v. *Burnet*, 286 U.S. 417; *United States* v. *Lewis*, 340 U.S. 590; *Healy* v. *Commissioner*, 345 U.S. 278; see also *Security Mills Co.* v. *Commissioner*, *supra*. In the *Lewis* and *Healy* cases it was held that a taxpayer who received money under a mistaken or invalid claim, and became obliged in a later year to refund part of it, was nonetheless required to report the full amount received in the year of receipt because the money had been received under a claim of right and was treated by the taxpayer as belonging to him. The Court stated in *Healy* (345 U.S. at 282-285):

> The phrase "claim of right" is a term known of old to lawyers. Its typical use has been in real property law in dealing with title by adverse possession, where the rule has been that title can be acquired by adverse possession only if the occupant claims that he has a right to be in possession as owner. The use of the term in the field of income taxation is analogous. There is a claim of right when funds are received and treated by a taxpayer as belonging to him. The fact that subsequently the claim is found to be invalid by a court does not change the fact that the claim did exist. A mistaken claim is nonetheless a claim, *United States* v. *Lewis*, 340 U.S. 590 (1951):
>
> * * * * *

The inequities of treating an amount as income which eventually turns out not to be income are urged upon us. * * * Congress has enacted an annual accounting system under which income is counted up at the end of each year. It would be disruptive of an orderly collection of the revenue to rule that the accounting must be done over again to reflect events occurring after the year for which the accounting is made, and would violate the spirit of the annual accounting system. This basic principle cannot be changed simply because it is of advantage to a taxpayer or to the Government in a particular case that a different rule be followed.

* * * * *

The so-called "claim of right doctrine" and its rationale lend strong support to the government's position. Since the annual accounting rule requires a taxpayer who receives income under a claim of right and without restriction as to its use to report it in the year received, notwithstanding that he may later be required to *refund* the very income received, it would seem to follow that a taxpayer must report income in the year received even though he may later be required to *use* some or all of it to meet alleged "related" expenses. See *Streight Radio and Television, Inc.* v. *Commissioner*, 280 F. 2d 883 (C.A. 7th), affirming 33 T.C. 127, certiorari denied, 366 U.S. 965; *Spencer, White & Prentis* v. *Commissioner*, 144 F. 2d 45 (C.A. 2d), affirming 1943 P-H T.C. Memorandum Decisions, par. 43,306, certiorari denied, 323 U.S. 780; *South Dade Farms* v. *Commissioner*, 138 F. 2d 818 (C.A. 5th), affirming 1942 P-H B.T.A. and T.C.

was includable in gross income in the year of receipt. Expressly recognizing a conflict with *Bressner Radio, Inc.* v. *Commissioner*, 267 F. 2d 520 (C.A. 2d), involving a similar method of accounting with respect to prepaid income for service guaranties, this Court granted certiorari and affirmed. It pointed out (pp. 690-692) that while the taxpayer's accounting method had been regularly and consistently employed, and was also in accord with generally accepted commercial accounting practices, it "fails to respect the criteria of annual tax accounting" required by the taxing statute, and, moreover, was "artificial" since rendition of the service was contingent upon members' demands. As a separate and independent ground for its decision, the Court pointed (pp. 694-697) to pertinent legislative history showing that Section 452 of the 1954 Code (dealing with "prepaid income") expressly authorized the very method of accounting employed by the taxpayer, but that Congress retroactively repealed the section and has subsequently refused to re-enact it despite repeated efforts to reinstate the repealed provisions.

The Studio (Br. 18-20) and amicus (Br. 12-14) attempt to distinguish *AAA* on the theory that the Association could not demonstrate that its method of accounting "precisely matched" receipts against estimated future "related costs" of performing services, since the services there contracted for were to be rendered upon demand and were therefore uncertain and contingent; whereas here the contracts called for a specific number of lessons and the Studio's method

did "accurately match" its receipts against estimated related future service expenses.[18]

It is true that the Court, both in *AAA* and its predecessor, *Automobile Club of Michigan* v. *Commissioner,* 353 U.S. 180, pointed to the contingent nature of the services as a factor making the method of deferral used "artificial". Additionally, the Court distinguished *Beacon Publishing Co.* v. *Commissioner,* 218 F. 2d 697 (C.A. 10th), and *Schuessler* v. *Commissioner,* 230 F. 2d 722 (C.A. 5th), on the ground that in those cases the taxpayer was required "to furnish services at specified times in years subsequent to the tax year" while, in the case of the automobile clubs, "substantially all services are performed only upon a member's demand and the taxpayer's performance was not related to fixed dates after the tax year" (353 U.S. at 189, n. 20; 367 U.S. at 691, n. 4). Even assuming, however, that the *AAA* decision leaves open the validity of such a distinction, this case would fall on the *AAA*, rather than the *Beacon Publishing,* side of the line. While the contracts were nominally for a stated number of dance lessons to be given within

[18] It is anomalous to speak, as do the Studio and Amicus throughout their briefs, of an accounting system which "accurately and precisely matches" income currently received for future services with "related costs of [future] performance". The "related costs" which they would "match" against a current year's income consist of nothing more than a *presently estimated amount of future service expenses* to be incurred in a subsequent year. An income-deferral system based upon matching current income with estimated yet-to-be incurred expenses may hardly be dignified as an "accurate and precise" accounting system.

stated time limits, the services were not to be performed, as in *Beacon* and *Schuessler*, at "fixed dates" in the future but only as and when demanded by the student. Nor is that a merely formal distinction, for the Studio's experience has been that a large proportion of the lessons contracted for are never taken, with the result that its actual performance under any individual contract is in fact uncertain and contingent. As we have stated, a substantial number of the contracts were cancelled when the student failed to appear for a year, others were renegotiated for a lesser number of lessons, and, presumably, individual lessons were skipped without any adjustment. While the automobile clubs' per-month method of accrual was at least consistent with their actual group experience, the Studio's per-lesson method of accrual (based on the false assumption that all lessons contracted for will be taken) is contradicated by its own experience.

More importantly, however, we do not believe that the *AAA* decision can be limited, as the Studio and amicus would limit it, to cases in which the services to be performed are uncertain. Under the annual accounting requirement and related accrual concepts, compensation must be reported as gross income in the taxable year in which the right to receive it becomes fixed (in this case the year in which it was collected under claim of right and without restriction as to its use), and may not be diminished by a "matching" amount of estimated future service expenses which the

recipient admittedly has not yet incurred but merely expects to incur in a later year.[19]

Furthermore, the distinction which the Studio and amicus seek to draw between *AAA* and this case does not meet the second and independent ground for decision in *AAA*. Pointing to "other considerations requiring our affirmance" (367 U.S. at 694), the Court went on to demonstrate, from the history of the 1954 Code and its amendments dealing with the income-deferral problem, affirmative Congressional endorsement of the view long held by the Commissioner and the courts disallowing the deferral of income for tax purposes.[19a] From that demonstration the Court concluded that it should follow the established administrative and judicial practice barring deferral and leave to Congress the carving out of appropriately limited exceptions, a course made particularly desirable by "the complications inherent in the problem and its seriousness to the general revenue" (367 U.S. at 697). Whatever may be said of the implication of the first part of the opinion, there is nothing in the rationale of the latter part by which to confine it to contingent-service contracts. That ground of the decision is applicable to *any* method of deferral of prepaid service income—whether the services are to be rendered on certain or uncertain dates in the future—and was properly found to be controlling by the courts below.

---

[19] See Costelloe, "Con Edison and AAA cases seen as landmarks in the law of tax accounting", 15 J. Taxation 216 (October 1961)

[19a] See, *e.g.*, the passage from the Senate Report quoted at 367 U.S. 694-695, note 8, reproduced *infra*, pp. 58-59, note 36.

2. The Studio's accounting system violates the annual accounting rule and related accrual principles.

(*a*) *The transactional or "earned income" method of accounting urged by the Studio.*—The Studio's method of accounting, on its face, fails to satisfy the annual accounting requirement and related accrual concepts. Instead of accruing and reporting as gross income in each taxable year the entire amount of compensation received in that year, and deducting only expenses actually incurred and losses actually sustained in the same year, the Studio has excluded ("deferred") from gross income all payments assumed to be "related" to future service expenses. This deferral of items of gross income currently received in order to reflect estimated items of deduction not yet incurred cannot be squared with the injunction in *Security Mills* (321 U.S. at 286–287) against "allocating income or outgo to a year other than the year * * * in which the right to receive, or the obligation to pay, has become final and definite in amount." Far from clearly reflecting its "net income" for a single "taxable year" on the basis of gross income actually accrued and expenses actually incurred within that year, as demanded by the statute and this Court's decisions, the Studio's returns purported to reflect the net result of its service contracts over a period of two or more taxable years (indeed, over a lifetime in the case of life contracts).

In advocating approval of its method of accounting, the Studio and amicus misconceive the fundamental tax accounting principles which they purportedly accept. Contrary to their assumption, in

determining taxable income for a given taxable year on the accrual method it is immaterial whether gross income and deduction items enumerated in the taxing statute stem from the same contract or are otherwise transactionally "related." The only relevant question is whether the taxpayer had a fixed "right to receive" the gross income item or a fixed "liability to pay" the deduction item within the taxable year. Insofar as they appear to accept the correct test, petitioner and amicus escape the normal result only by making an assumption contrary to fact and inventing a rule of law which finds no support in the statute, Treasury Regulations, or the controlling decisions. The fact assumed is that the Studio had no fixed "right to receive" the advance payments for services at the times it did receive them; the rule supposed is that a "right to receive" payment in no event arises until the services are performed, *i.e.*, when the related service expenses are incurred.

The first premise fails to distinguish between the absolute right, accorded the Studio by the terms of its service contracts, to receive compensation in advance of performance (which gives rise to accrual of the compensation), and a contingent obligation to refund all or part of the prepaid compensation in the event it failed to perform (an event which would give rise to a deductible loss for breach of the contract).[20]

---

[20] Even in such event, the loss would not be deductible on the accrual basis until the year in which the liability for the damages became fixed. See *Lucas* v. *American Code Co.*, 280 U.S. 445, where the Court said (p. 450): "Obviously, the mere refusal to perform a contract does not justify the deduction, as a loss, of the anticipated damages." Similarly, the mere

While the right to receive normally precedes actual receipt, it can arise no later than the time the taxpayer *actually receives* the income under a claim of right and treats it as his own. Indeed, there is no better evidence of a fixed right to receive income than its receipt under claim of right, coupled with its unrestricted use by the recipient. One who demands and collects money pursuant to the terms of his contract, and enjoys all its economic benefits, is scarcely in a position to maintain that he had no fixed right to receive it. In this case, the Studio unquestionably acquired a fixed "right to receive" in the taxable year the amounts which it did collect in that year from students in advance of giving dancing lessons. The amounts admittedly were collected under claim of right, pursuant to its contract with the student, were received without restriction as to their use, and were deposited in its general bank account. (R. 251.) The Studio not only had a right to *receive* the amounts collected, but a right to *retain* them whether or not the lessons paid for were taken; upon cancellation of a contract the Studio normally made no refund of prepaid amounts, thereby realizing substantial "gains from cancellation." (R. 253-256.) Since one who receives money under a claim of right and without restriction as to its use must report it in the year received even though he may be required to refund it in a later year (*Healy* v. *Commissioner*, *supra*; *United States* v. *Lewis*, *supra*; *Security Mills* v. *Com-*

obligation to perform a contract does not justify the deduction of the anticipated expenses of performance. *Spencer, White & Prentis* v. *Commissioner*, *supra*.

missioner, supra), *a fortiori* one who receives it irrevocably must report it in the year received even though he expects to incur future related expenses.[20a]

The second premise underlying the Studio's argument, a corollary of the first, disregards the annual accounting requirement and would substitute a transactional system of accounting by permitting a taxpayer to report as gross income from service contracts only that portion of prepaid compensation which he treats as "earned" under the respective contracts during the taxable year.[21] In contending that the federal income tax is imposed only upon "earned" income, which they vaguely define as the result of "matching" items of gross income against "related" items of deduction, the Studio and amicus seek to cut across annual accounting periods and employ a "hybrid system, partly annual and partly transactional"—a system which, as this Court held in *Security Mills* (p. 287), finds no place in the statutory scheme for computing federal income tax liability. The situation here is essentially no different from any other in which a taxpayer on the accrual basis receives income in one taxable year, out of which expenses or losses will have to be paid in a later year. Under long settled tax accounting principles, the tax on the income in the year of receipt

---

[20a] Even monies illegally obtained and used are taxable in the year of receipt. See *Rutkin* v. *United States*, 343 U.S. 130.

[21] That the Studio is advocating a transactional as distinguished from an annual method of accounting is apparent from the example given in fn. 6 (p. 15) of its brief. Moreover, the table set forth in its Exhibit 31 (R. 215), upon which it relies, points up the distortion of its annual net taxable income (gross less deductions), resulting from its deferral of gross income received in one taxable year to a later year through the attempted "matching" of estimated, future service expenses.

may not be withheld or diminished by excluding or deducting from the gross income a reserve to cover an estimated amount of anticipated expenses, or losses. See *Brown v. Helvering, supra.* Basically the same transactional or "earnings" approach advocated by the Studio was rejected by this Court in the *AAA* case.[22]

The term "earnings" has never been used in the income tax statutes to describe either the object of the tax or its method of computation or reporting.[23] And

---

[22] The Second Circuit's decision in *Bressner Radio, Inc.* v. *Commissioner*, 267 F. 2d 520, typical of the lower courts decisions upon which the amicus relies, appears irreconcilable with its decision in the *Spencer, White & Prentis* v. *Commissioner*, 144 F. 2d 45, certiorari denied, 323 U.S. 780. See also *Commissioner* v. *Fifth Avenue Coach Lines*, 281 F. 2d 556 (C.A. 2d), certiorari denied, 366 U.S. 964. *Bressner* was not followed by the Seventh Circuit in *Streight Radio and Television, Inc.* v. *Commissioner*, 280 F. 2d 883, certiorari denied, 366 U.S. 965, which presented the same issue. In Rev. Rul. 60-85, 1960-1 Cum. Bull. 181, the Internal Revenue Service announced that it would not follow *Bressner*, stating:

> The *Bressner Radio Inc.*, decision conflicts in principle with a long line of judicial authority holding that where a taxpayer receives prepaid income under a claim of right and without restriction as to its disposition, it must report the entire amount received each year as income. * * *

This Court (367 U.S. at 689) predicated its grant of certiorari in the *AAA* case upon conflict with *Bressner*, and its *AAA* decision effectively overruled that decision.

[23] Under the 1939 Code (Sections 11 and 12) the tax is imposed on the "net income." The term "net income" is defined in Section 21 as "the gross income computed under section 22, less the deductions allowed by section 23." Section 41 provides that the taxpayer's computation of "The net income" must clearly reflect "the income". The statutory scheme in the 1954 Code is basically the same, except that the term "taxable income" has been substituted for "net income". See Sections 61,

this Court has specifically rejected the notion that "earnings"—rather than annual "net income"—forms the basis of tax accounting. As stated in *Guaranty Trust Co. v. Commissioner*, 303 U.S. 493, 498:

> It is true that the acts of Congress taxing income have consistently laid the tax upon the net income received by or accrued to the taxpayer in a "taxable year," which is either the calendar year or a different fiscal year, as the taxpayer may elect. But they have never undertaken to limit the income taxable in any one year to that derived from the taxpayer's activities occurring in that or any other single year. The items of gross income and of allowed deductions to be included in the income return, are those of the taxpayer for his taxable year, even though they may have resulted from or be affected by his business transactions of other years. *Burnet v. Sanford & Brooks Co., supra*, 364, 365. Circumstances wholly fortuitous may determine the year in which income, whenever earned, is taxable, and may thus affect the amount of tax. Receipt of income or accrual of

63, 161–175, 241–247, 441, and 446, Internal Revenue Code of 1954. Compare the use of the term "earnings and profits" in Section 115 of the 1939 Code (Section 316 of the 1954 Code), relating to dividend distributions. As the Tax Court observed in *Streight Radio and Television, Inc. v. Commissioner*, 33 T.C. 127, 138, affirmed, 280 F. 2d 883 (C.A. 7th), certiorari denied, 366 U.S. 965: "Tax accounting does not concern itself with the fine question of whether items have been 'earned' in the accounting sense, * * * and this is true whether the item in question has been received, or is merely a receivable." See also *South Dade Farms v. Commissioner*, 138 F. 2d 818, 819 (C.A. 5th); *Automobile Club of New York v. Commissioner*, 32 T.C. 906, 912, affirmed, 304 F. 2d 781 (C.A. 2d); *Spencer, White & Prentis v. Commissioner, supra.*

664298—62——4

> the right to receive it within the tax year is the test of taxability, not the time it has taken the taxpayer to earn it * * *.

The transactional or "earnings" theory of tax accounting urged by taxpayer ignores the rationale of the annual accounting rule, to say nothing of the rule itself. As pointed out in *Sanford & Brooks, supra*, and again in *Security Mills*, the annual accounting system is rooted in strong practical and policy consideration—the need of the government for an ascertainable amount of revenue at regular intervals, collectible through a system capable of practical operation. By requiring an accrual basis taxpayer to report gross income when the right to receive it becomes fixed, and to deduct liabilities when all the events have occurred which fix both the fact and amount of the liability, the annual accounting system permits the taxpayer to compute, and the Commissioner to assess, the tax on the basis of facts rather than estimates. Moreover, these standards apply uniformly to accrual basis taxpayers in all types of business situations. The transactional or earnings approach, on the other hand, would place on the Commissioner the enormous burden of evaluating and verifying complex statistical evidence submitted by millions of taxpayers in an endless variety of business contexts to prove that they have reliably "related" and "matched" present income with estimated future expenses, or present expenses with estimated future

income.[24] Revenue agents will not only become involved in technical accounting problems in order to determine the validity and accuracy of the taxpayer's estimates in the first instance, but will be obliged to re-audit the taxpayer's accounts in later years to ascertain whether subsequent business experience corresponds with the taxpayer's previous estimates. And in cases where there is a variance between prior estimates and subsequent experience, adjustments of the resultant understatement or overstatement of actual "earnings" in earlier years, as well as adjustments of the taxpayer's current estimates to assure that past errors will not be perpetuated, will become necessary. Moreover, by "matching" against current income estimated future expenses, the taxpayer may effectively postpone the collection of tax until a later period without any guarantee that he will later be able to pay the tax.[25]

[24] See Schapiro, "Tax Accounting for Prepaid Income and Reserves for Future Expenses," Tax Revision Compendium, submitted to the Committee on Ways and Means (1959), Vol. 2, pp. 1133, 1142–1145.

[25] The difficulties inherent in a system of "matching" future expenses against current receipts are magnified in cases where, as here, indefinite term or lifetime contracts are involved. Moreover, in such cases the "deferred" or "unearned" portion of the prepaid income would not only be increased, but the taxable year to which it would be allocated would be postponed far into the future. In addition, adoption of a "matching" system would pose insurmountable problems of ascertaining how much of the taxpayer's anticipated future overhead expenses (*e.g.* rent, salaries, entertainment, advertising, utilities, taxes, etc.) are allocable to a particular contract and are to be "matched" against the prepaid income received under that contract, especially in cases where (as here) the taxpayer enters into numerous contracts.

Adoption of the transactional or "earnings" approach would also pose difficult problems for the courts. It would invite litigation as to whether particular items of income and expense are sufficiently "related" to justify their being "matched", either by a deferral of income or the accrual of a reserve for estimated expenses; and, even if there is a discernible relationship between such items, as to whether the tabulations and ratios submitted by the taxpayer, or those prepared by revenue agents, more accurately reflect that relationship. The courts would thus inevitably become embroiled in accounting controversies far more numerous, complex, and time-consuming than those they are now called upon to decide under the annual accounting rule.

(*b*) *Commercial accounting practices.*—There is no warrant for the amicus' contention (Br. 31-35)[28] that the annual accounting rule and related accrual concepts laid down by this Court in federal income tax cases must yield to commercial (non-tax) accounting principles. It has often been emphasized that generally accepted commercial accounting practices are not controlling for purposes of computing federal income tax liability. *Brown* v. *Helvering, supra; Security Mills, supra; Lucas* v. *American Code Co.*, 280 U.S. 445; *Bazley* v. *Commissioner*, 331 U.S. 737, 741; *Commissioner* v. *Hansen*, 360 U.S. 446; *American Automobile Assn.* v. *United States*, 367 U.S. 687. Even accounting methods prescribed by federal regulatory agencies to insure compliance with other federal statutes are not determinative of tax

[28] See also fn. 5 (p. 15) of taxpayer's brief.

liability under the Revenue Acts. *Old Colony R. Co. v. Commissioner*, 284 U.S. 552, 562; *Mine Hill & Schuylkill Haven R. Co. v. Smith*, 184 F. 2d 422 (C.A. 3d), certiorari denied, 340 U.S. 932; *Kansas City Southern Ry. Co. v. Commissioner*, 52 F. 2d 372, 378 (C.A. 8th), certiorari denied, 284 U.S. 676. What constitutes a fair and accurate statement of a taxpayer's income in a report to creditors or stockholders, or even for purposes of complying with some other statute, does not necessarily coincide with what must be reported as income under the taxing statute; each report is designed to serve discrete needs and objectives. "Many reserves set up by prudent business men are not allowable as deductions". *Brown v. Helvering*, *supra*, 291 U.S. at 202. As the Court stated in *Weiss v. Wiener*, 279 U.S. 333, 335: "The income tax laws do not profess to embody perfect economic theory. They ignore some things that either a theorist or a business man would take into account in determining the pecuniary condition of the taxpayer. * * *"

In *Spring City Co. v. Commissioner*, 292 U.S. 182, the Court held that an accrual basis taxpayer who sold

---

[22] The amicus points (Br. 27-28) to a provision in the Treasury Regulations under the 1954 Code (Section 1.446-1(a)(2)) that "generally accepted accounting principles in a particular trade or business * * * will ordinarily be regarded as clearly reflecting income". This is hardly an unqualified approval of all commercial accounting practices. Moreover, the Regulations proceed to explain that an accounting method used by the taxpayer will be acceptable only "if it accords with generally recognized and accepted *income tax accounting principles* and is consistently used by the taxpayer from year to year". (Emphasis added.) Regulations Section 1.446-1(c)(ii), Appendix, *infra*, pp. 88-89.

goods to one who became insolvent during the taxable year was required to accrue and report the full sale gain for federal income tax purposes, notwithstanding that under accepted business accounting practices it was proper to defer the portion which the seller did not expect to collect from the insolvent vendee. The Court stated (p. 189–190):

> Petitioner insists that "good business practice" forbade the inclusion in the taxpayer's assets of the account receivable in question or at least the part of it which was subsequently found to be uncollectible. But that is not the question here. Questions relating to allowable deductions under the income tax act are quite distinct from matters which pertain to an appropriate showing upon which credit is sought. It would have been proper for the taxpayer to carry the debt in question in a suspense account awaiting the ultimate determination of the amount that could be realized upon it, and thus to indicate the status of the debt in financial statements of the taxpayer's condition. But that proper practice, in order to advise those from whom credit might be sought of uncertainties in the realization of assets, does not affect the construction of the statute, or make the debt deductible in 1920, when the entire debt was not worthless, when the amount which would prove uncollectible was not yet ascertained, rather than in 1923 when that amount was ascertained and its deduction allowed.

Recently, in *Commissioner* v. *Hansen, supra,* the Court held that an automobile dealer was not entitled to exclude from its gross income a "dealer's reserve", representing a portion of the sales price withheld by finance companies, even though it was the "common

pattern" (p. 448) and "consistent practice" (p. 452) in the trade to treat such reserves as unaccrued and unearned until paid over to the dealer. The more recent decision in *American Automobile Assn., supra*, is directly in point. It was there admitted, by the government (p. 691), as the Court of Claims had found, that the taxpayer's income-deferral method was "in accord with generally accepted [commercial] accounting principles"; nevertheless, the Court held (p. 692) that the method "fails to respect the criteria of annual tax accounting and may be rejected by the Commissioner."

It is noteworthy that for general business purposes the accounting profession has ascribed a meaning to "net income" which differs significantly from the meaning of that term as used in the Internal Revenue Code and consistently applied by this Court. The term has been defined by the American Institute of Accountants (the amicus) as synonymous with "earnings" over a "period of years", and as having reference, moreover, to "the results of operations after deducting from revenues all related costs and expenses and all other charges and losses assigned to the period."[6] Furthermore, the transactional or "earn-

[6] The American Institute of Accountants, in its Accounting Terminology Bulletin No. 2, pp. 3-4 (March, 1955), defines "net income" as follows:

> The terms *net income* or *net profit* refer to the results of operations after deducting from revenues all related costs and expenses and all other charges and losses assigned to the period.
>
> * * * * * *
>
> The term earnings is not used uniformly but it is generally employed as a synonym for "net income," particularly over a period of years. * * *

ings" method of arriving at "net income", approved by the accounting profession for commercial accounting purposes, entails allocations of "charges and credits" which are "estimated" and are "based on assumptions as to future events which may be invalidated by experience."[29] Such a method of accounting, while it may serve useful business purposes, is completely at odds with settled tax accounting precepts.

In any event, there is no reason to suppose that application of generally accepted commercial accounting practices in the area of prepaid income would more clearly reflect "true" net income for a given tax accounting period than the application of established tax accounting rules. Indeed, the accounting profession itself candidly recognizes that commercial accounting practices are diverse and inexact—that they sanction different procedures, and often produce disparate calculations of net income for a particular period.[30] To substitute the "earned income" theory of accounting espoused by the amicus for the annual

[29] As stated by the American Institute of Accountants in its Accounting Research Bulletin No. 43, p. 59 (1953):

> Allocations to fiscal periods of both charges and credits affecting the determination of net income are, in part, estimated and conventional and based on assumptions as to future events which may be invalidated by experience. While the items of which this is true are usually few in relation to the total number of transactions they sometimes are large in relation to the other amounts in the income statement.

[30] In a recent article the former President of the American Institute of Certified Public Accountants (the amicus in this case) stated:

> There is some reason to believe that this phrase—'generally accepted accounting principles"—suggests to the or-

accounting rule and related accrual principles would not, therefore, furnish any practical solution to the accounting problem presented by this case.

dinary reader the existence of some authoritative code of accounting, which when applied consistently will produce precise and comparable results. The appearance of precision is strengthened by the reporting of net income in exact dollars and cents, instead of rounded approximations.

Now, we accountants know that "generally accepted accounting principles" are far from being a clearly defined, comprehensive set of rules, which will ensure identical accounting treatment of the same kind of transaction in every case in which it occurs. We know that "generally accepted accounting principles" are broad concepts evolving from the actual practices of business enterprises, and reflected in the literature of the accounting profession. To be sure, many of these principles have been formally defined or clarified in the accounting research bulletins of the American Institute. But we all know that in some areas there are equally acceptable alternative principles or procedures for the accounting treatment of identical items, one of which might result in an amount of net income reported in any one year widely different from the amount an alternative procedure might produce.

Yet, I suspect it would come as something of a shock to some people to realize that two otherwise identical corporations might report net income differing by millions of dollars simply because they followed different accounting methods—and that the financial statements of both companies might still carry a certified public accountant's opinion stating that the reports fairly presented the results in accordance with "generally accepted accounting principles." Eaton, "Financial Reporting in a Changing Society," 104 Journal of Accountancy 21, 26-27 (August 1957); see also Spacek, "Can We Define Generally Accepted Accounting Principles," 106 Journal of Accountancy 40 (December 1958); Knauth, "An Executive Looks at Accounting," 103 Journal of Accountancy 29 (January 1957); Wienshienk, "Accountants and the Law," 96 Pa. Law Rev. 48 (1947).

(*c*) *The Treasury Regulations.*—The amicus also stresses (Br. 26–30) those provisions of the Treasury Regulations which authorize use of the "accrual" in lieu of the "cash" method of accounting. See Regulations under the 1954 Code Sections 1.446–1, 1.451–1, 1.461–1, Appendix, *infra*, pp. 85–99. But nothing in the Regulations permits a taxpayer who chooses the accrual system to postpone reporting prepaid service income in order to "match" the income against future (yet-to-be-incurred) service expenses. On the contrary, the Regulations explicitly provide that "[u]nder an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy." Regulations Section 1.451–1(a).[1] The succeeding sentence of the Regulations which the amicus emphasizes (Br. 28–29) furnishes no basis for its inference that the Regulations authorize an accrual basis taxpayer to postpone reporting advance receipts for services. It deals with amounts not yet received, and provides that "if" no determination can be made as to the right to receive compensation for services until the services are completed, the compensation ordinarily is income for the taxable year in which the determination can be made. The very sentence relied upon by the amicus contemplates that there may be situations where the taxpayer's right to receive (and

[1] Conversely, [u]nder an accrual method of accounting an expense is deductible for the taxable year in which all the events have occurred which determine the fact of liability and the amount thereof can be determined with reasonable accuracy." Regulations Section 1.461–1(a)(2).

corresponding duty to accrue) compensation antedates performance of the services. Such a situation exists where, as here, under the terms of the service contract the taxpayer is entitled to and does receive payment in advance for future services. Thus, Rev. Rul. 60-85, 1960-1 Cum. Bull. 181-182, addressed to the precise situation here presented, specifically provides that:

> where a taxpayer receives prepaid income under a claim of right and without restriction as to its disposition, it must report the entire amount received each year as income. * * *
>
> Accordingly, the Service will continue its general policy of taxing prepaid income in the year of receipt. This policy applies to income from contracts to furnish services and to other types of prepaid income, such as prepaid royalties, rent, bonuses, etc., regardless of whether the period of proration is definite or indefinite, unless a different treatment is specifically provided in the Internal Revenue Code of 1939 or 1954 or the regulations thereunder.

Moreover, the Treasury Regulations are to be read as a whole, not by isolating one part from another. The interpretation which the amicus places upon the Regulations renders superfluous the long standing provisions of the Regulations specifically authorizing use of either a "percentage of completion" or "completed contract" method of reporting income from "long-term contracts", defined as "building, installation, or construction contracts" covering a period in excess of one year. Regulations 118, Section 39.42-4 under the 1939 Code, Appendix, *infra*, pp. 81-82; Regulations under the 1954 Code, Section 1.451-3,

Appendix, *infra*, pp. 95-96. See also *Burnet* v. *Sanford & Brooks Co.*, 282 U.S. 359, 366. No claim is or can be made that the Studio's contracts to furnish dancing lessons constituted "long-term contracts" falling within the purview of the Regulations.

In short, it is the Studio, not the Commissioner, who is seeking to circumvent the "all events" test enunciated in the Regulations and decisions.

(*d*) *The decisions relied upon by the Studio and amicus.*—Neither the Studio nor the amicus points to any decision which sanctions the deferral, for federal income tax purposes, of prepaid service income. Indeed, the cases upon which they mainly rely (e.g. *United States* v. *Anderson*, 269 U.S. 422) support the government's position. They involved deduction items, and they hold that such items are deductible on the accrual basis only in the taxable year in which the taxpayer's liability to pay them becomes fixed. In contravention of those decisions the Studio is here attempting, by way of "deferral" of "unearned income", to deduct estimated future service expenses from a current year's gross income.

In *Anderson* the Court sustained the Commissioner's determination that a munitions tax was deductible in the year it was imposed (1916), not in the following year in which it became due and payable, because (pp. 440-441) "all the events" had occurred in the earlier year to "fix the amount of the tax and determine the liability of the taxpayer to pay it." [32]

[32] In *Anderson* the Court was interpreting T.D. 2433, 19 Treasury Decisions, Internal Revenue 5 (1917), promulgated under Section 13(d) of the Revenue Act of 1916, c. 463, 39

Nothing in the opinion may fairly be read as supporting the proposition that accrual of an item of gross income may be postponed from the taxable year in which it is received under claim of right and without restriction as to its use until some later year in which related expense items become deductible." To be sure, in *Anderson* (p. 440) the Court spoke of "charging against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period." But when the opinion is read as a whole, and in the light

---

Stat. 756, wherein Congress for the first time provided that a return might be made in accordance with a taxpayer's books of account. T.D. 2433 limited the accrual of reserves for tax purposes to reserves for liabilities actually "incurred" during the taxable year; reserves for contingent liabilities were expressly disapproved. It further provided that "in cases wherein deductions are made on the accrual basis as hereinbefore indicated income from fixed and determinable sources accruing to the corporations must be returned, for the purpose of the tax, on the same basis."

In the instant case "all of the events" obviously had *not* occurred in the taxable year to fix the Studio's "liability to pay" for the related expenses of performance which it seeks to match against the advance receipts. For example, compensation to instructors, a major item of expense, was based on the number of hours of lessons actually taught by them (R. 155-156); hence the Studio had no obligation (fixed or otherwise) to pay compensation to an instructor except as and when he gave lessons. The Studio's contractual obligation to students *to incur* expenses of performance may not be equated with deductible expenses *already incurred*. See *Spencer, White & Prentis v. Commissioner, supra*; *Straight Radio and Television, Inc. v. Commissioner, supra*. Here as in *Spencer, White & Prentis* (p. 47), "liability for the work done after * * * [the taxable year] had not been incurred for the work had not been performed."

of later decisions of this and other courts,[34] it is clear that the Court—far from sanctioning any deferral-of-prepaid income method of accounting—was there strictly applying the annual accounting rule to a taxpayer claiming deductions on the accrual basis. In *Spencer, White & Prentis* v. *Commissioner, supra,* which involved essentially the same issue here presented, the Court stated (p. 47):

> The petitioner's reliance upon *United States* v. *Anderson,* 269 U.S. 422, 46 S. Ct. 131, 70 L. Ed. 347, is misplaced. There the deduction of certain estimated tax liabilities set up in a reserve entered on the taxpayer's books in accordance with a Treasury Regulation was allowed, though the taxes had not been assessed. But all the events had occurred which determined the liability to pay the tax. Here liability for the work done after * * * [the

[34] Whatever else may be said of *Anderson,* it continues to be cited by this Court primarily for the proposition that an expense is deductible on the accrual basis only in the taxable year when it is incurred, i.e., when all the events have occurred which fix the liability to pay and determine its amount. *United States* v. *Consolidated Edison Co.,* 366 U.S. 380, 385 *Dixie Pine Co.* v. *Commissioner,* 320 U.S. 516, 519; *Aluminum Castings Co.* v. *Routzahn,* 282 U.S. 92, 96; *Lucas* v. *Ox Fibre Brush Co.,* 281 U.S. 115, 120; *Lucas* v. *American Code Co.,* 280 U.S. 445, 452. See also *Security Mills, supra,* pp. 286-287; Guaranty *Trust Co., supra,* p. 498; *Brown* v. *Helvering, supra.* Significantly, *Anderson* was relied upon by the Second Circuit in support of the deferral system involved in *Bressner Radio, Inc.* v. *Commissioner; supra,* but that case, as previously noted, was effectively overruled in *American Automobile Assn.* v. *United States,* 367 U. S. 687, 689. Cf. concurring opinion of Judge Clark in *Automobile Club of New York, Inc.* v. *Commissioner,* 304 F. 2d 781 (C.A. 2d).

taxable year] had not been incurred for the work had not been performed. * * *

Unless inconsistent accrual principles are to govern for purposes of determining when gross income and deduction items respectively accrue, the "all events" test applied in *Anderson* demands accrual of the income items here in question. For when the Studio received advance payments for lessons to be furnished, pursuant to the terms of its contract with students, "all the events" had occurred to "fix" its right to receive payment and the amount receivable—albeit that in some later year the taxpayer might be required either to refund the income or to incur related deductible expenses. *Security Mills Co.* v. *Commissioner, supra.*

Levin v. *Commissioner*, 219 F. 2d 588 (C.A. 3d), also relied upon by the Studio (Br. 17–18), likewise involved a deduction item and supports the government's position. It was there held that an accrual basis partnership which contracted in one taxable year to pay for advertising services to be rendered in the following year was not entitled to deduct as an expense of the taxable year the full amount payable under the contract because its liability to pay remained contingent in that year. In this case, as in *Levin*, the Studio is improperly attempting (in the guise of deferral of prepaid income) to deduct service expenses which it had no liability to pay in the taxable year. *Helvering* v. *Union Pacific Co.*, 293 U.S. 282, also cited by the Studio (Br. 12–15), involved an issue far removed from that here presented; it was there held that a corporation issuing bonds was en-

titled to amortize discount and commission allowed over the life of the bond.

As for the cases involving income accrual, upon which the Studio and amicus rely (e.g. *Spring City Co. v. Commissioner*, 292 U.S. 182; *Continental Tie & Lumber Co. v. United States*, 286 U.S. 290), they too support the Government's position. They illustrate the proposition that income must be reported on the accrual basis in the year when the "right to receive" it becomes fixed, which of course may precede the year of actual receipt. Nothing in the opinions of those cases even remotely suggests that a taxpayer who receives compensation under a claim of right and without restriction as to its use has no fixed "right to receive" it in the accrual accounting sense merely because it is received for services to be performed in the future.

B. Congress has authorized only two classes of taxpayers to use a deferral method of accounting for prepaid service income, and the Studio admittedly does not fall within either class

If more were needed to support the decision below, there are "other considerations requiring our affirmance" (*American Automobile Assn.* v. *United States, supra*, p. 694): (1) the history of the enactment and repeal of 1954 Code Sections 452 and 462, dealing respectively with deferral of prepaid income and deduction of reserves for estimated expenses; and (2) the history of the recent enactments of Sections 455 and 456, permitting income deferral, subject to carefully defined safeguards and limitations, by two specified classes of taxpayers (publishers and mem-

bership organizations)—classes to which the Studio admittedly does not belong.[35]

In the *AAA* case, the court pointed out (p. 695) that Section 452, which permitted deferral of income received for future services, "overruled the long administrative practice of the Commissioner and holdings of the courts in disallowing such deferral of income for tax purposes," and that its repeal the following year—

> confirms our view that the method used by the Association could be rejected by the Commissioner. While the claim is made that Congress did not "intend to disturb prior law as it affected permissible accrual accounting pro-

[35] Nor does the Studio come within any of the specific statutory exceptions to the annual accounting rule. See Section 44 of the Internal Revenue Code of 1939, and Section 453 of the Internal Revenue Code of 1954 (installment sales); Section 122 of the Internal Revenue Code of 1939, and Section 172 of the Internal Revenue Code of 1954 (net operating loss deduction); Section 23(k) of the Internal Revenue Code of 1939, and Section 166 of the Internal Revenue Code of 1954 (bad debt reserves); Sections 201(c)(2) and 202 of the Internal Revenue Code of 1939 (credit for estimated liability reserves of life insurance companies); Sections 802, 803(b) and 804(a), Internal Revenue Code of 1954 (deduction for estimated liability reserves of life insurance companies); Sections 204(b)(6) and (7), (c) (1) and (4), Internal Revenue Code of 1939, and Sections 832(b) (5) and (6), (c) (1) and (4), Internal Revenue Code of 1954 (definitions of "losses incurred" and "expenses incurred" with respect to deductions allowed insurance companies other than life and mutual); Section 461(c), Internal Revenue Code of 1954 (proration of real property taxes related to a definite period of time); Section 171, Internal Revenue Code of 1954 (amortizable bond premium); Sections 1301-1304, Internal Revenue Code of 1954 (long-term compensation).

664298 62 5

visions for tax purposes." H.R. Rep. No. 293, 84th Cong., 1st Sess. 4–5, the cold fact is that it repealed the only law incontestably permitting the practice upon which the Association depends. To say that, as to taxpayers using such systems, Congress was merely declaring existing law when it adopted § 452 in 1954, and that it was merely restoring unaffected the same prior law when it repealed the new section in 1955 for good reason, is a contradiction in itself, "varnishing nonsense with the charm of sound." Instead of constituting a merely duplicative creation, the fact is that § 452 for the first time specifically declared petitioner's system of accounting to be acceptable for income tax purposes, and overruled the long-standing position of the Commissioner and courts to the contrary. And the repeal of the section the following year, upon insistence by the Treasury that the proposed endorsement of such tax accounting would have a disastrous impact on the Government's revenue, was just as clearly a mandate from the Congress that petitioner's system was not acceptable for tax purposes. * * * [36]

---

[36] It is plain from the Senate Finance Committee's Report accompanying the 1954 Code that Congress understood prepaid service income to be includible in gross income for the year of receipt, whether the taxpayer used the accrual or the cash method of accounting. Thus in explanation of Section 452 ("Prepaid Income"), which authorized substantially the same deferral method of accounting as the Studio here employed, the Report stated (S. Rep. No. 1622, 83d Cong., 2d Sess., p. 301 (3 U.S.C. Cong. & Adm. News (1954) 4621, 4940)):

> Under the 1939 Code, *regardless of the method of accounting*, with minor exceptions established by regulations or administrative practice, amounts are includible in gross income by the recipient not later than the time of receipt

The Court further pointed out (p. 696) that the later addition of Section 455, permitting publishers to defer prepaid subscription income, coupled with denial of similar relief to automobile clubs with respect to prepaid membership dues, made it abundantly clear that Congress did not intend to grant such relief generally to all taxpayers. Moreover, since the AAA decision, Congress has re-confirmed that intention by adding to the Code a section specifically authorizing—again with carefully delineated restrictions and safeguards—automobile clubs and certain other membership organizations to defer prepaid dues income for taxable years after 1960. Section 456 of the 1954 Code, added by Section 1, Act of July 26, 1961, 75 Stat. 222. See H. Rep. No. 381, 87th Cong., 1st Sess. (1961-2 Cum. Bull. 390). Significantly, omnibus bills designed generally to permit deferral of income received for future services have been introduced in the Congress, but have not been passed.[37]

Thus the accounting problem which this case presents has been under continuing legislative study, and Congress has chosen to deal with the problem on

---

> if they are subject to free and unrestricted use by the taxpayer even though the payments are for goods and services to be provided by the taxpayer at a future time. [Emphasis ours.]

As this Court pointed out in its AAA opinion (367 U.S. at 695-697), the repeal of 1954 Code Section 452 within a year after its enactment reinstated the law as it existed under the 1939 Code.

[37] See H.R. 8688, 86th Cong., 1st Sess., and H.R. 2245 and 2440, 87th Cong., 1st Sess., referred to the Ways and Means Committee, each a bill "To amend the Internal Revenue Code of 1954 to provide for the deferment of income from service contracts".

a selective step-by-step basis, and even as to the two classes singled out for special treatment it has imposed conditions and limitations for the protection of the revenue. Given this pattern of legislative activity, we submit that it would be highly inappropriate for the courts to attempt to carve out additional exceptions to the annual accounting rule in favor of classes of taxpayers other than those specified in the statute. In the concluding words of this Court in *AAA* (p. 697):

> To recapitulate, it appears that Congress has long been aware of the problem this case presents. In 1954 it enacted § 452 and § 462, but quickly repealed them. Since that time Congress has authorized the desired accounting only in the instance of prepaid subscription income, which, as was pointed out in *Michigan*, is ratably earned by performance on "publication dates after the tax year." 353 U.S. 180, 189, note 20. It has refused to enlarge § 455 to include prepaid membership dues. At the very least, this background indicates congressional recognition of the complications inherent in the problem and its seriousness to the general revenue. We must leave to the Congress the fashioning of a rule which, in any event, must have wide ramifications. The Committees of the Congress have standing committees expertly grounded in tax problems, with jurisdiction covering the whole field of taxation and facilities for studying considerations of policy as between the various taxpayers and the necessities of the general revenues. The validity of the long established policy of the Court in deferring, where possible, to congressional pro-

cedures in the tax field is clearly indicated in this case. * * *

The policy expressed in AAA of leaving to Congress the determination when, and in what circumstances, income deferral is permissible applies with equal force to the deferral system of accounting employed by the taxpayer here. If dance studios—or, for that matter, any taxpayer other than a publisher or membership organization qualifying under 1954 Code, Sections 455 and 456—are to be permitted to defer the reporting of income otherwise currently includible in gross income, the authorization and the concomitant protective provisions should come from Congress, not the courts.[38]

---

[38] The "complications inherent in the problem" and its "wide ramifications", to which the Court adverted in the AAA case (p. 697), are numerous. To mention but a few: (1) If the reporting of service income is deferred beyond the taxable year in which received, should not the deduction of expenses paid or incurred in that year, but attributable to the deferred income, also be deferred? (2) How define a "service contract"; *e.g.*, should it embrace a contract for the use of property, or a sale accompanied by a service warranty? (3) How deal with two discrete service liabilities created by a single contract, one to be performed in the current year and the other over several years? (4) Over how long a period should income-deferral be permitted in the case of long-term or lifetime service contracts?

The impact upon the revenue must also be considered. A change from current to deferred reporting would involve important one-time adjustments, and in many cases result not only in reduced tax liability for the year of transition, but in creating a net operating loss carry-back or carry-forward to other years. Consideration should also be given to requiring the revenue loss in the year of transition to be spread over several years.

C. Assuming arguendo that taxable income may be computed on a transactional rather than an annual basis, the Studio's method of accounting was properly rejected as even more artificial than that rejected in American Automobile Assn. v. United States

Thus far we have argued, as we did in the *AAA* case, that *any* system of accounting which fails to report prepaid service income in the taxable year of receipt, even though the income has not yet been "earned" by performance of the service paid for in advance, is contrary to the scheme of federal income taxation and may be rejected by the Commissioner. This Court in *AAA* apparently agreed, for it held that the income-deferral system there involved "fails to respect the criteria of annual tax accounting", and transgressed the clear Congressional "mandate" (manifested by repeal of 1954 Code, Sections 452 and 462) rendering such systems "not acceptable for tax purposes". 367 U.S. at 692, 695. However, it sustained the Commissioner's rejection of the Association's deferral system on the *further* ground that it was "purely artificial", i.e., "substantially all services are performed only upon a member's demand and the taxpayer's performance was not related to fixed dates after the tax year." 367 U.S. at 691. See also *Automobile Club of Michigan v. Commissioner*, 353 U.S. 180, 189, note 20.

If, as we submit, any system of deferral of prepaid service income (other than those specifically authorized by the special provisions of 1954 Code, Sections 455 and 456) must be rejected as violating settled tax accounting principles, then there is no need to determine whether the particular system of deferral employed by the taxpayer should be rejected on the

alternative and independent ground that it is "artificial". But even assuming *arguendo* that such an inquiry were necessary, we submit that the Studio's system of accounting was no less artificial than that condemned in *American Automobile Assn.*

In the first place, the Studio's contracts did not provide for the giving of lessons on fixed dates after the taxable year, but left such dates to be arranged from time to time by the student and his instructor. In fact, many students paid for lessons without ever demanding or arranging that they be given, with the result that a substantial part of the taxable income returned by the Studio each year was attributable to "Gains from cancellation" of contracts rather than "Earned Income". (R. 256.) "Gains from cancellation", of course, represented monies which the Studio had collected (either in advance or in installments) for lessons which it had not been, and never would be, called upon to give.[9] Thus, the record establishes beyond question that the Studio's right to receive (and retain) the advance payments was in no way contingent upon the actual performance of services. On the contrary, it establishes that the Studio's liability to perform services was entirely contingent upon the student's demands. In the words of this Court in *American Automobile Assn.* (p. 692), "no, some, or all the services paid for * * * may or may

---

[9] Refunds which the Studio occasionally made were charged against "Deferred Income" before "Gains from cancellation" were computed. (R. 253.) Accordingly, "Gains from cancellation" represent the Studio's "unearned" profit from its contracts after allowance of refunds.

not be rendered", and there was no "fixed individual expense or performance justification" for its accounting system.

Furthermore, the Studio's accounting system carries a feature which stamps it as even more artificial than the Association's. Whereas the Association treated certain operating expenses (*e.g.*, commissions paid to personnel for selling contracts to members) "as prepaid membership costs and deducted [them] ratably over the same periods of time as those over which dues were recognized as income" (367 U.S., p. 690), the Studio deducted all of its "related" expenses in the taxable year they were paid or incurred, without regard to when the amounts received under its contracts were reported as "earned." Commissions to sales personnel, for example, were deducted when paid, as were the percentage royalties paid to Arthur Murray on each week's receipts. (R. 218–219, 252.) Consistency would require that these expenses, instead of having been deducted in the year of payment, should have been treated as deductions only in the subsequent year in which the "related" gross income items were treated as "earned." Under its accounting system, however, the Studio was claiming the best of both worlds—immediate deduction of expenses and deferral of "related" gross income. The Commissioner, we submit, was amply justified in rejecting such a system of accounting.

In any event, whether or not the Studio's system is deemed artificial, we think it is clear that the "long standing position of the Commissioner and courts",

and the repeal of the "only law incontestably permitting the practice upon which the * * * [Studio] depends" (367 U.S. at 695) fully justifies the Commissioner's refusal to approve the Studio's method of accounting for advance receipts.

II. THE FUTURE INSTALLMENTS

THE STUDIO WAS REQUIRED TO ACCRUE AND REPORT FUTURE INSTALLMENTS REPRESENTING SERVICES RENDERED DURING THE YEAR (REGARDLESS OF THE CONTRACTUAL DATE FOR PAYMENT) AND FUTURE INSTALLMENTS DUE UNDER THE CONTRACT DURING THE YEAR (REGARDLESS OF THE CONTRACTUAL OR ACTUAL DATE OF PERFORMANCE):

The burden of our argument thus far has been that payments actually received without restriction as to use must be deemed accrued income. But, in addition to supporting this proposition, most of the authorities already discussed also teach that income often accrues *before* receipt—when the right to receive becomes fixed. Ordinarily, it is performance of the services which fixes the amount and the right to receive payment. But, exceptionally, the parties may agree otherwise. The contract may provide that the right to payment antedates the obligation to perform.

As we have seen, that is the situation here. These atypical contracts[*] call for down payment of a por-

[*] In this connection it may be noted that at least one state (California) has recently enacted legislation designed to prevent dance studios from engaging in practices which result in forfeitures of advance payments. Declaring that "the purpose" of such legislation is "to safeguard the public against fraud, deceit, imposition and financial hardship * * * by prohibiting or restricting false or misleading advertising, onerous contract terms, harmful financial practices * * * by which the public has been injured in connection with contracts for health and dance studio services", the California statute (1) prohibits

tion of the stipulated price and installment payments of the balance, without regard to when, or whether, lessons will actually be requested by the students. Neither the amounts payable nor the due dates of the installments bear any relationship to the number of lessons expected to have been given at the time of payment. Normally, payments were made when due and the rule applicable to actual receipts would apply. But there were, of course, defaults and delays in payments. These are our present concern.

Under the circumstances of this case, it is clear that the right to receive accrued, at the latest, when payment became due under the agreement, even though not then made. Neither the creditor's failure to demand payment, nor the debtor's refusal to pay, can affect the legal right to receive a matured installment. And, under settled principles, once that right has ripened, income is deemed accrued. The consequence is that accrued income in any given year includes: (1) payments actually received, (2) payments presently

---

dance studios from entering into contracts measured by the life of the person receiving the services, from requiring payments over a period exceeding two years from the date of the contract or in a total amount exceeding $500, and from cutting off defenses by assignment of the contract or negotiation of notes received thereunder; and (2) requires every contract for dance studio services to contain a provision for refund of prepayments, and for relief from further payments, upon the death or disability of the person contracting for the service. Title 2.5, California Civil Code (Sections 1812.50-1812.95), added by Stat. 1961, c. 1675, § 1.

due under the contract, and (3) promised compensation for services already performed, regardless of the contractual date for payment.

Initially, the Commissioner went further, asserting that installment payments should be accrued even before they became due, since the signing of the contract itself fixed the amount and the right to ultimately receive them. Upon reconsideration, however, we concede the error of accruing future payments which are neither due as a matter of contract, nor matured by performance of the related services. Indeed, the Studio's right to collect the installment on its due date depends on its continuing ability and willingness to perform. Until that time, its right to receive payment has not fully ripened.

Because neither the Commissioner nor the taxpayer segregated amounts received, matured installments, and payments not yet due, disposition of the case on the basis outlined will require re-examination of the studio's books and records and appropriate new findings. Accordingly, we urge a remand of the cause for this purpose.

CONCLUSION

For the foregoing reasons, it is respectfully submitted (1) that the judgment of the court of appeals should be affirmed in so far as it is predicated upon inclusion in the Studio's gross income for the respec-

tive taxable years involved of the amounts received by it in those years in cash or its equivalent; and (2) that the case should be remanded for a determination of the additional amounts includible by reason of its having acquired a fixed right to receive them in those years.

ARCHIBALD COX,
Solicitor General.

LOUIS F. OBERDORFER,
Assistant Attorney General.

HARRY BAUM,
GIORA BEN-HORIN,
Attorneys.

NOVEMBER 1962.

APPENDIX

Internal Revenue Code of 1939:

SEC. 21. NET INCOME.

(a) *Definition.*—"Net income" means the gross income computed under section 22, less the deductions allowed by section 23.

* * * * *

(26 U.S.C. 1952 ed., Sec. 21.)

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

(26 U.S.C. 1952 ed., Sec. 22.)

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) [As amended by Sec. 121(a), Revenue Act of 1942, c. 619, 56 Stat. 798] *Expenses.*—

(1) *Trade or business expenses.*—

(A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services

actually rendered; * * * and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

* * * * *

(e) *Losses by Individuals.*—In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

(1) if incurred in trade or business; or

(2) if incurred in any transaction entered into for profit, though not connected with the trade or business; * * *

* * * * *

(26 U.S.C. 1952 ed., Sec. 23.)

Sec. 41. General Rule.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

(26 U.S.C. 1952 ed., Sec. 41.)

Sec. 42 [As amended by Sec. 114, Revenue Act of 1941, c. 412, 55 Stat. 687]. Period in Which Items of Gross Income Included.

(a) *General Rule.*—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *

* * * * *

(26 U.S.C. 1952 ed., Sec. 42.)

SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

The deductions and credits (other than the corporation dividends paid credit provided in section 27) provided for in this chapter shall be taken for the taxable year in which "paid or accrued" or "paid or incurred", dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. * * *

* * * * *

(26 U.S.C. 1952 ed., Sec. 43.)

SEC. 48. DEFINITIONS.

When used in this chapter—

(a) *Taxable Year.*—"Taxable year" means the calendar year, or the fiscal year ending during such calendar year, upon the basis of which the net income is computed under this Part. * * *

* * * * *

(c) *"Paid or Incurred", "Paid or Accrued."*—The terms "paid or incurred" and "paid or accrued" shall be construed according to the method of accounting upon the basis of which the net income is computed under this Part.

* * * * *

(26 U.S.C. 1952 ed., Sec. 48.)

Internal Revenue Code of 1954:

SEC. 61. GROSS INCOME DEFINED.

(a) *General Definition.*—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, and similar items;

(2) Gross income derived from business;

(3) Gains derived from dealings in property;

(4) Interest;

(5) Rents;

(6) Royalties;

(7) Dividends;

(8) Alimony and separate maintenance payments;

(9) Annuities;

(10) Income from life insurance and endowment contracts;

(11) Pensions;

(12) Income from discharge of indebtedness;

(13) Distributive share of partnership gross income;

(14) Income in respect of a decedent; and

(15) Income from an interest in an estate or trust.

(b) *Cross References.*—

For items specifically included in gross income, see part II (sec. 71 and following). For items specifically excluded from gross income, see part III (sec. 101 and following).

* * * * *

(26 U.S.C. 1958 ed., Sec. 61.)

SEC. 63. TAXABLE INCOME DEFINED.

(a) *General Rule.*—Except as provided in subsection (b), for purposes of this subtitle the

term "taxable income" means gross income, minus the deductions allowed by this chapter, other than the standard deduction allowed by part IV (sec. 141 and following).

* * * * *

(26 U.S.C. 1958 ed., Sec. 63.)

SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) *In General.*—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

(2) traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity. For purposes of the preceding sentence, the place of residence of a Member of Congress (including any Delegate and Resident Commissioner) within the State, congressional district, Territory, or possession which he represents in Congress shall be considered his home, but amounts expended by such Members within each taxable year for living expenses shall not be deductible for income tax purposes in excess of $3,000.

* * * *

(26 U.S.C. 1958 ed., Sec. 162.)

SEC. 165. LOSSES.

(a) *General Rule.*—There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

(b) *Amount of Deduction.*—For purposes of subsection (a), the basis for determining the amount of the deduction for any loss shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

(c) *Limitation on Losses of Individuals.*—In the case of an individual, the deduction under subsection (a) shall be limited to—

(1) losses incurred in a trade or business;

(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and * * *

* * * * *

(26 U.S.C. 1958 ed., Sec. 165.)

SEC. 441. PERIOD FOR COMPUTATION OF TAXABLE INCOME.

(a) *Computation of Taxable Income.*—Taxable income shall be computed on the basis of the taxpayer's taxable year.

(b) *Taxable Year.*—For purposes of this subtitle, the term "taxable year" means—

(1) the taxpayer's annual accounting period, if it is a calendar year or a fiscal year;

(2) the calendar year, if subsection (g) applies; or

(3) the period for which the return is made, if a return is made for a period of less than 12 months.

(c) *Annual Accounting Period.*—For purposes of this subtitle, the term "annual accounting period" means the annual period on the basis of which the taxpayer regularly computes his income in keeping his books.

(d) *Calendar Year.*—For purposes of this subtitle, the term "calendar year" means a period of 12 months ending on December 31.

(e) *Fiscal Year.*—For purposes of this subtitle, the term "fiscal year" means a period of

12 months ending on the last day of any month other than December. In the case of any taxpayer who has made the election provided by subsection (f), the term means the annual period (varying from 52 to 53 weeks) so elected.

* * * * * * *

(26 U.S.C. 1958 ed., Sec. 441.)

SEC. 446. GENERAL RULE FOR METHODS OF ACCOUNTING.

(a) *General Rule.*—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

(b) *Exceptions.*—If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income.

(c) *Permissible Methods.*—Subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting—

(1) the cash receipts and disbursements method;

(2) an accrual method;

(3) any other method permitted by this chapter; or

(4) any combination of the foregoing methods permitted under regulations prescribed by the Secretary or his delegate.

(d) *Taxpayer Engaged In More Than One Business.*—A taxpayer engaged in more than one trade or business may, in computing taxable income, use a different method of accounting for each trade or business.

(e) *Requirement Respecting Change of Accounting Method.*—Except as otherwise expressly provided in this chapter, a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before com-

puting his taxable income under the new method, secure the consent of the Secretary or his delegate.

(26 U.S.C. 1958 ed., Sec. 446.)

SEC. 451. GENERAL RULE FOR TAXABLE YEAR OF INCLUSION.

(a) *General Rule.*—The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

* * * * *

(26 U.S.C. 1958 ed., Sec. 451.)

SEC. 461. GENERAL RULE FOR TAXABLE YEAR OF DEDUCTION.

(a) *General Rule.*—The amount of any deduction or credit allowed by this subtitle shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

* * * * *

(26 U.S.C. 1958 ed., Sec. 461.)

Treasury Regulations 118 (1939 Code):

SEC. 39.41-1 *Computation of net income.*—Net income must be computed with respect to a fixed period. Usually that period is 12 months and is known as the taxable year. Items of income and of expenditure which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money. The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a

manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. (See §§ 39.42-1 to 39.42-3, inclusive.) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it.

SEC. 39.41-2 *Bases of computation and changes in accounting methods.*—(a) Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. See section 48 for definitions of "*paid or accrued*" and "paid or incurred." All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. But see sections 42 and 43. See also section 48. For instance, in any case in which it is necessary to use an inventory, no method of accounting in regard to purchases and sales will correctly reflect income except an accrual method. A taxpayer is deemed to have received items of gross income which have been credited to or set apart for him without restriction. (See §§ 39.42-2 and 29.42-3.) On the other hand, appreciation in value of property is not even an accrual of income to a taxpayer prior to the realization of such appreciation through sale or conversion of the property. (But see § 39.22(e)-5.)

(b) The true income, computed under the Internal Revenue Code, and if the taxpayer keeps books of account, in accordance with the method of accounting regularly employed in keeping such books (provided the method so used is properly applicable in determining the net income of the taxpayer for purposes of taxation), shall in all cases be entered in the return. If for any reason the basis of reporting income subject to tax is changed, the taxpayer shall attach to his return a separate statement setting forth for the taxable year and for the preceding year the classes of items differently treated under the two systems, specifying in particular all amounts duplicated or entirely omitted as the result of such change.

(c) A taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. For the purposes of this section, a change in the method of accounting employed in keeping books means any change in the accounting treatment of items of income or deductions, such as a change from cash receipts and disbursements method to the accrual method, or vice versa; a change involving the basis of valuation employed in the computation of inventories (see §§ 39.22(c)-1 to 39.22(c)-8, inclusive); a change from the cash or accrual method to the long-term contract method, or vice versa; a change in the long-term contract method from the percentage of completion basis to the completed contract basis, or vice versa (see § 39.42-4); or a change involving the adoption of, or a change in the use of, any other specialized basis of computing net income such as the crop basis (see §§ 39.22(a)-7 and 39.23(a)-11). Application for permission to change the method of accounting employed and the basis upon which the return is made shall be filed within 90 days after the

beginning of the taxable year to be covered by the return. The application shall be accompanied by a statement specifying the classes of items differently treated under the two methods and specifying all amounts which would be duplicated or entirely omitted as a result of the proposed change. Permission to change the method of accounting will not be granted unless the taxpayer and the Commissioner agree to the terms and conditions under which the change will be effected. See section 22(d) and §§ 39.22(d)-1 to 39.22(d)-7, inclusive, with respect to changing to the last-in first-out method of inventorying goods.

(d) Section 44 contains special provisions for reporting the profit derived from the sale of property on the installment plan.

(e) The foregoing requirements relative to a change of accounting method are not applicable if a taxpayer desires to adopt the installment basis of returning income, as provided in §§ 39.44-1 and 39.44-3, but are applicable if a taxpayer desires to change from such basis to a straight accrual basis. In cases where permission to make such change is granted, the taxpayer will be required to return as additional income for the taxable year in which the change is made all the profit not theretofore returned as income pertaining to the payments due on installment sales contracts as of the close of the preceding taxable year.

SEC. 39.41-3. *Methods of accounting.*—It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. Each taxpayer is required by law to make a return of his true income. He must, therefore, maintain such accounting records as will enable him to do so. (See section 54 and § 39.54-1.) Among the essentials are the following:

(a) In all cases in which the production, purchase, or sale of merchandise of any kind is an income-producing factor, inventories of the merchandise on hand (including finished goods, work in process, raw materials, and supplies) should be taken at the beginning and end of the year and used in computing the net income of the year (see section 22(c) and §§ 39.22(c)-1 to 39.22(c)-8, inclusive);

(b) Expenditures made during the year should be properly classified as between capital and expense; that is to say, expenditures for items of plant, equipment, etc., which have a useful life extending substantially beyond the year should be charged to a capital account and not to an expense account; and

(c) In any case in which the cost of capital assets is being recovered through deductions for wear and tear, depletion, or obsolescence, any expenditure (other than ordinary repairs) made to restore the property or prolong its useful life should be added to the property account or charged against the appropriate reserve and not to current expenses.

SEC. 39.41-4. *Accounting period.*—The return of a taxpayer is made and his income computed for his taxable year, which in general means his fiscal year, or the calendar year if he has not established a fiscal year. (See section 48.) The term "fiscal year" means an accounting period of 12 months ending on the last day of any month other than December. No fiscal year will, however, be recognized unless before its close it was definitely established as an accounting period by the taxpayer and the books of such taxpayer were kept in accordance therewith. A person having no such fiscal year must make his return on the basis of the calendar year. Except in the case of a first return for income tax a taxpayer shall make his return on the basis upon which he made his return for the taxable year immedi-

ately preceding unless, with the approval of the Commissioner, he has changed his accounting period. See § 39.46-1.

Sec. 39.42-1 *When included in gross income—(a) In general.* Except as otherwise provided in section 42, gains, profits, and income are to be included in the gross income for the taxable year in which they are received by the taxpayer, unless they are included as of a different period in accordance with the approved method of accounting followed by him. See §§ 39.41-1 to 39.41-3, inclusive. * * *

* * * * *

Sec. 39.42-4 *Long-term contracts.* (a) Income from long-term contracts is taxable for the period in which the income is determined, such determination depending upon the nature and terms of the particular contract. As used in this section, the term "long-term contracts" means building, installation, or construction contracts covering a period in excess of one year from the date of execution of the contract to the date on which the contract is finally completed and accepted. Persons whose income is derived in whole or in part from such contracts may, as to such income, prepare their returns upon either of the following bases:

(1) Gross income derived from such contracts may be reported upon the basis of percentage of completion. In such case there should accompany the return certificates of architects or engineers showing the percentage of completion during the taxable year of the entire work to be performed under the contract. There should be deducted from such gross income all expenditures made during the taxable year on account of the contract, account being taken of the material and supplies on hand at the beginning and end of the taxable period for use in connection with the work under the contract but not yet so applied.

(2) Gross income may be reported for the taxable year in which the contract is finally completed and accepted if the taxpayer elects as a consistent practice so to treat such income, provided such method clearly reflects the net income. If this method is adopted there should be deducted from gross income all expenditures during the life of the contract which are properly allocated thereto, taking into consideration any material and supplies charged to the work under the contract but remaining on hand at the time of completion.

(b) A taxpayer may change his method of accounting to accord with subparagraphs (1) and (2) of paragraph (a) of this section only after permission is secured from the Commissioner as provided in § 39.41-2.

* * * * *

SEC. 39.43-1 *"Paid or incurred" and "paid or accrued."* (a) The terms "paid or incurred" and "paid or accrued" will be construed according to the method of accounting upon the basis of which the net income is computed by the taxpayer. (See section 48(c).) The deductions and credits provided for in chapter 1 (other than the dividends paid credit provided in section 27) must be taken for the taxable year in which "paid or accrued" or "paid or incurred," unless in order clearly to reflect the income such deductions or credits should be taken as of a different period. If a taxpayer desires to claim a deduction or a credit as of a period other than the period in which it was "paid or accrued" or "paid or incurred," he shall attach to his return a statement setting forth his request for consideration of the case by the Commissioner together with a complete statement of the facts upon which he relies. However, in his income tax return he shall take the deduction or credit only for the taxable period in which it was actually "paid or incurred," or "paid or accrued," as

the case may be. Upon the audit of the return, the Commissioner will decide whether the case is within the exception provided by the Internal Revenue Code, and the taxpayer will be advised as to the period for which the deduction or credit is properly allowable.

* * * * *

SEC. 39.43-2 *When charges deductible.*—Each year's return, so far as practicable, both as to gross income and deductions therefrom, should be complete in itself, and taxpayers are expected to make every reasonable effort to ascertain the facts necessary to make a correct return. The expenses, liabilities, or deficit of one year cannot be used to reduce the income of a subsequent year. A taxpayer has the right to deduct all authorized allowances, and it follows that if he does not within any year deduct certain of his expenses, losses, interest, taxes, or other charges, he cannot deduct them from the income of the next or any succeeding year. It is recognized, however, that particularly in a going business of any magnitude there are certain overlapping items both of income and deduction, and so long as these overlapping items do not materially distort the income they may be included in the year in which the taxpayer, pursuant to a consistent policy, takes them into his accounts. * * *

Treasury Regulations on Income Taxes (1954 Code):

§ 1.441-1 PERIOD FOR COMPUTATION OF TAXABLE INCOME.—(a) *Computation of taxable income.*—Taxable income shall be computed and a return shall be made for a period known as the "taxable year." For rules relating to methods of accounting, the taxable year for which items of gross income are included and deductions are taken, inventories, and adjustments, see sections 446 to 482, inclusive, and the regulations thereunder.

(b) *Taxable year.* (1) the term "taxable year" means

(i) The taxpayer's annual accounting period, if it is a calendar year or a fiscal year;

(ii) The calendar year, if section 441(g) (relating to taxpayers who keep no books or have no accounting period) applies; or

(iii) The period for which the return is made, if the return is made under section 443 for a period of less than 12 months, referred to as a "short period."

(2) A taxable year may not cover a period of more than 12 calendar months except in the case of a 52-53-week taxable year. See § 1.441-2.

(3) A new taxpayer in his first return may adopt any taxable year which meets the requirements of section 441 and this section without obtaining prior approval. The first taxable year of a new taxpayer must be adopted on or before the time prescribed by law (not including extensions) for the filing of the return for such taxable year. However, for rules applicable to the adoption of a taxable year by a partnership, see § 1.442-1(b)(2), section 706(b), and § 1.706-1(b). For rules applicable to the taxable year of a member of an affiliated group which makes a consolidated return, see § 1.1502-14 and § 1.442-1(d).

(4) After a taxpayer has adopted a calendar or a fiscal year, he must use it in computing his taxable income and making his returns for all subsequent years unless prior approval is obtained from the Commissioner to make a change or unless a change is otherwise permitted under the internal revenue laws or regulations. See section 442 and § 1.442-1. For rules applicable to changes in taxable years of partners and partnerships, see also section 706(b) and § 1.706-1(b).

(c) *Annual accounting period.*—The term "annual accounting period" means the annual period (calendar year or fiscal year) on the

basis of which the taxpayer regularly computes his income in keeping his books.

(d) *Calendar year.*—The term "calendar year" means a period of 12 months ending on December 31. A taxpayer who has not established a fiscal year must make his return on the basis of a calendar year.

(e) *Fiscal year.*—(1) The term "fiscal year" means—

(i) A period of 12 months ending on the last day of any month other than December, or

(ii) The 52–53-week annual accounting period, if such period has been elected by the taxpayer.

(2) A fiscal year will be recognized only if it is established as the annual accounting period of the taxpayer and only if the books of the taxpayer are kept in accordance with such fiscal year.

* * * * *

(g) *No books kept; no accounting period.*

* * *

* * * * *

Records which are sufficient to reflect income adequately and clearly on the basis of an annual accounting period will be regarded as the keeping of books.

* * * * *

SEC. 1.446–1 GENERAL RULE FOR METHODS OF ACCOUNTING.—(a) *General rule.*—(1) Section 446(a) provides that taxable income shall be computed under the method of accounting on the basis of which a taxpayer regularly computes his income in keeping his books. The term "method of accounting" includes not only the over-all method of accounting of the taxpayer but also the accounting treatment of any item. Examples of such over-all methods are the cash receipts and disbursements method, an accrual method, combinations of such

methods, and combinations of the foregoing with various methods provided for the accounting treatment of special items. These methods of accounting for special items include the accounting treatment prescribed for research and experimiental expenditures, soil and water conservation expenditures, depreciation, net operating losses, etc. Except for deviations permitted or required by such special accounting treatment, taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books. For requirement respecting the adoption or change of accounting method, see section 446(e) and paragraph (e) of this section.

(2) It is recognized that no uniform method of accounting can be prescribed for all taxpayers. Each taxpayer shall adopt such forms and systems as are, in his judgment, best suited to his needs. However, no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year.

(3) Items of gross income and expenditures which are elements in the computation of taxable income need not be in the form of cash. It is sufficient that such items can be valued in terms of money. For general rules relating to the taxable year for inclusion of income and for taking deductions, see sections 451 and 461, and the regulations thereunder.

(4) Each taxpayer is required to make a return of his taxable income for each taxable

year and must maintain such accounting records as will enable him to file a correct return. See section 6001 and the regulations thereunder. Accounting records include the taxpayer's regular books of account and such other records and data as may be necessary to support the entries on his books of account and on his return as, for example, a reconciliation of any differences between such books and his return. The following are among the essential features that must be considered in maintaining such records:

(i) In all cases in which the production, purchase, or sale of merchandise of any kind is an income-producing factor, merchandise on hand (including finished goods, work in process, raw materials, and supplies) at the beginning and end of the year shall be taken into account in computing the taxable income of the year. (For rules relating to computation of inventories, see sections 471 and 472, and the regulations thereunder.)

(ii) Expenditures made during the year shall be properly classified as between capital and expense. For example, expenditures for such items as plant and equipment, which have a useful life extending substantially beyond the taxable year, shall be charged to a capital account and not to an expense account.

(iii) In any case in which there is allowable with respect to an asset a deduction for depreciation, amortization, or depletion, any expenditures (other than ordinary repairs) made to restore the asset or prolong its useful life shall be added to the asset account or charged against the appropriate reserve.

(b) *Exceptions.*—(1) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation of taxable income shall be made in a manner which, in the opinion of the Commissioner, does clearly reflect income.

(2) A taxpayer whose sole source of income is wages need not keep formal books in order to have an accounting method. Tax returns, copies thereof, or other records may be sufficient to establish the use of the method of accounting used in the preparation of the taxpayer's income tax returns.

(c) *Permissible methods.*—(1) *In general.*—Subject to the provisions of paragraphs (a) and (b) of this section, a taxpayer may compute his taxable income under any of the following methods of accounting:

(i) *Cash receipts and disbursements method.*—Generally, under the cash receipts and disbursements method in the computation of taxable income, all items which constitute gross income (whether in the form of cash, property, or services) are to be included for the taxable year in which actually or constructively received. Expenditures are to be deducted for the taxable year in which actually made. For rules relating to constructive receipt, see § 1.451-2. For treatment of an expenditure attributable to more than one taxable year, see section 461(a) and § 1.461-1(a)(1).

(ii) *Accrual method.*—Generally, under an accrual method, income is to be included for the taxable year when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Under such a method, deductions are allowable for the taxable year in which all the events have occurred which establish the fact of the liability giving rise to such deduction and the amount thereof can be determined with reasonable accuracy. The method used by the taxpayer in determining when income is to be accounted for will be acceptable if it accords with generally recognized and accepted income tax accounting principles and is consistently used by

the taxpayer from year to year. For example, a taxpayer engaged in a manufacturing business may account for sales of his product when the goods are shipped, when the product is delivered or accepted, or when title to the goods passes to the customer, whether or not billed, depending upon the method regularly employed in keeping his books. Likewise, the extent to which indirect costs shall be included in computing cost of goods sold depends upon the method used by the taxpayer in treating such items in keeping his books.

(iii) *Other permissible methods.*—Special methods of accounting are described elsewhere in chapter 1 of the Internal Revenue Code and the regulations thereunder. For example, see the following sections and the regulations thereunder: Sections 61 and 162, relating to the crop method of accounting; section 453, relating to the installment method; section 451, relating to the long-term contract methods. In addition, special methods of accounting for particular items of income, and expense are provided under other sections of chapter 1. For example, see section 174, relating to research and experimental expenditures, and section 175, relating to soil and water conservation expenditures.

(iv) *Combinations of the foregoing methods.*—(*a*) In accordance with the following rules, any combination of the foregoing methods of accounting will be permitted in connection with a trade or business if such combination clearly reflects income and is consistently used. Where a combination of methods of accounting includes any special methods, such as those referred to in subdivision (iii) of this subparagraph, the taxpayer must comply with the requirements relating to such special methods. A taxpayer using an accrual method of accounting with respect to purchases and sales may use the cash method in computing all

other items of income and expense. However, a taxpayer who uses the cash method of accounting in computing gross income from his trade or business shall use the cash method in computing expenses of such trade or business. Similarly, a taxpayer who uses an accrual method of accounting in computing business expenses shall use an accrual method in computing items affecting gross income from his trade or business.

(*b*) A taxpayer using one method of accounting in computing items of income and deductions of his trade or business may compute other items of income and deductions not connected with his trade or business under a different method of accounting.

(2) *Special rules.*—(i) In any case in which it is necessary to use an inventory the accrual method of accounting must be used with regard to purchases and sales unless otherwise authorized under subdivision (ii) of this subparagraph.

(ii) No method of accounting will be regarded as clearly reflecting income unless all items of gross profit and deductions are treated with consistency from year to year. The Commissioner may authorize a taxpayer to adopt or change to a method of accounting permitted by this chapter although the method is not specifically described in the Income Tax Regulations if, in the opinion of the Commissioner, income is clearly reflected by the use of such method. Further, the Commissioner may authorize a taxpayer to continue the use of a method of accounting consistently used by the taxpayer, even though not specifically authorized by the Income Tax Regulations, if, in the opinion of the Commissioner, income is clearly reflected by the use of such method. See section 446(a) and paragraph (a) of this section, which require that taxable income shall be computed under the method of accounting on

the basis of which the taxpayer regularly computes his income in keeping his books, and section 446(e) and paragraph (e) of this section, which require the prior approval of the Commissioner in the case of changes in accounting method.

(d) *Taxpayer engaged in more than one business.*—(1) Where a taxpayer has two or more separate and distinct trades or businesses, a different method of accounting may be used for each trade or business, provided the method used for each trade or business clearly reflects the income of that particular trade or business. For example, a taxpayer may account for the operations of a personal service business on the cash receipts and disbursements method and of a manufacturing business on an accrual method, provided such businesses are separate and distinct and the methods used for each clearly reflect income. The method first used in accounting for business income and deductions in connection with each trade or business, as evidenced in the taxpayer's income tax return in which such income or deductions are first reported, must be consistently followed thereafter.

(2) No trade or business will be considered separate and distinct for purposes of this paragraph unless a complete and separable set of books and records is kept for such trade or business.

(3) If, by reason of maintaining different methods of accounting, there is a creation or shifting of profits or losses between the trades or businesses of the taxpayer (for example, through inventory adjustments, sales, purchases, or expenses) so that income of the taxpayer is not clearly reflected, the trades or businesses of the taxpayer will not be considered to be separate and distinct.

(e) ***Requirement respecting the adoption or change of accounting method.***—(1) A taxpayer

filing his first return may adopt any permissible method of accounting in computing taxable income for the taxable year covered by such return. See section 446(c) and paragraph (c) of this section for permissible methods. Moreover, a taxpayer may adopt any permissible method of accounting in connection with each separate and distinct trade or business, the income from which is reported for the first time. See section 446(d) and paragraph (d) of this section. See also section 446(a) and paragraph (a) of this section.

(2)(i) Except as otherwise expressly provided in chapter 1 of the Internal Revenue Code of 1954 and the regulations thereunder, a taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. A change in the method of accounting includes a change in the over-all method of accounting for gross income or deductions, or a change in the treatment of a material item. Consent must be secured, whether or not a taxpayer regards the method from which he desires to change to be proper. Thus, a taxpayer may not compute his taxable income under a method of accounting different from that previously used by him, unless such consent is secured.

(ii) Examples of changes requiring consent are: A change from the cash receipts and disbursements method to an accrual method, or vice versa; a change involving the method or basis used in the valuation of inventories (see sections 471 and 472 and the regulations thereunder); a change from the cash or accrual method to a long-term contract method, or vice versa (see § 1.451-3); a change involving the adoption, use, or discontinuance of any other specialized method of computing taxable income, such as the crop method; or a change in

the treatment of any other items of income or expense, where material.

(3) In order to secure the Commissioner's consent to a change of a taxpayer's method of accounting, the taxpayer must file an application by letter with the Commissioner of Internal Revenue, Washington 25, D.C., within 90 days after the beginning of the taxable year in which it is desired to make the change. The application shall be accompanied by a statement specifying the nature of the taxpayer's business, his present method of accounting, the method to which he desires to change, the taxable year in which the change is to be effected, the classes of items which would be treated differently under the new method, and all amounts which would be duplicated or omitted as a result of the proposed change. The Commissioner may require such other information as may be necessary in order to determine whether the proposed change will be permitted. Permission to change a taxpayer's method of accounting will not be granted unless the taxpayer and the Commissioner agree to the terms, conditions and adjustments under which the change will be effected. See section 481 and regulations thereunder, relating to certain adjustments required by such changes, section 472 and the regulations thereunder, relating to changes to and from the last-in, first-out method of inventorying goods, and section 453 and the regulations thereunder, relating to certain adjustments required by a change from an accrual method to the installment method.

* * * * *

SEC. 1.451-1 GENERAL RULE FOR TAXABLE YEAR OF INCLUSION.—(a) *General rule.*—Gains, profits, and income are to be included in gross income for the taxable year in which they are actually or constructively received by the taxpayer unless includible for a different year in accordance with the taxpayer's method of accounting. Under an accrual method of ac-

counting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Therefore, under such a method of accounting if, in the case of compensation for services, no determination can be made as to the right to such compensation or the amount thereof until the services are completed, the amount of compensation is ordinarily income for the taxable year in which the determination can be made. Under the cash receipts and disbursements method of accounting, such an amount is includible in gross income when actually or constructively received. Where an amount of income is properly accrued on the basis of a reasonable estimate and the exact amount is subsequently determined, the difference, if any, shall be taken into account for the taxable year in which such determination is made. To the extent that income is attributable to the recovery of bad debts for accounts charged off in the prior years, it is includible in the year of recovery in accordance with the taxpayer's method of accounting, regardless of the date when the amounts were charged off. For treatment of bad debts and bad debt recoveries, see sections 166 and 111 and the regulations thereunder. For rules relating to the treatment of amounts received in crop shares, see section 61 and the regulations thereunder. For the year in which a partner must include his distributive share of partnership income, see section 706(a) and § 1.706–1(a). If a taxpayer ascertains that an item should have been included in gross income in a prior taxable year, he should, if within the period of limitation, file an amended return and pay any additional tax due. Similarly, if a taxpayer ascertains that an item was improperly included in gross income in a prior taxable year, he should, if within the period of limitation,

file claim for credit or refund of any overpayment of tax arising therefrom.

* * * * * * *

SEC. 1.451-3 LONG-TERM CONTRACTS.—(a) *Definition.*—The term "long-term contracts" means building, installation, or construction contracts covering a period in excess of one year from the date of execution of the contract to the date on which the contract is finally completed and accepted.

(b) *Methods.*—Income from long-term contracts (as defined in paragraph (a) of this section), determined in a manner consistent with the nature and terms of the contract, may be included in gross income in accordance with one of the following methods, provided such method clearly reflects income:

(1) *Percentage of completion method.*—Gross income derived from long-term contracts may be reported according to the percentage of completion method. Under this method, the portion of the gross contract price which corresponds to the percentage of the entire contract which has been completed during the taxable year shall be included in gross income for such taxable year. There shall then be deducted all expenditures made during the taxable year in connection with the contract, account being taken of the material and supplies on hand at the beginning and end of the taxable year for use in such contract. Certificates of architects or engineers showing the percentage of completion of each contract during the taxable year shall be available at the principal place of business of the taxpayer for inspection in connection with an examination of the income tax return.

(2) *Completed contract method.*—Gross income derived from long-term contracts may be reported for the taxable year in which the contract is finally completed and accepted. Under this method, there shall be deducted

from gross income for such year all expenses which are properly allocable to the contract, taking into account any material and supplies charged to the contract but remaining on hand at the time of completion.

(e) *In general.*—Long-term contract methods of accounting apply only to the accounting for income and expenses attributable to long-term contracts. Other income and expense items, such as investment income or expenses not attributable to such contracts, shall be accounted for under a proper method of accounting. See section 446(c) and § 1.446-1(c). A taxpayer may change to or from a long-term contract method of accounting only with the consent of the Commissioner. See section 446(e) and § 1.446-1(e). When a taxpayer reports income under a long-term contract method, a statement to that effect shall be attached to his income tax return.

* * * * * *

SEC. 1.461-1 GENERAL RULE FOR TAXABLE YEAR OF DEDUCTION.—(a) *General rule.*—(1) *Taxpayer using cash receipts and disbursements method.*—Under the cash receipts and disbursements method of accounting, amounts representing allowable deductions shall, as a general rule, be taken into account for the taxable year in which paid. Further, a taxpayer using this method may also be entitled to certain deductions in the computation of taxable income which do not involve cash disbursements during the taxable year, such as the deductions for depreciation, depletion, and losses under sections 167, 611, and 165, respectively. If an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, such an expenditure may not be deductible, or may be deductible only in part, for the taxable year in

which made. An example is an expenditure for the construction of improvements by the lessee on leased property where the estimated life of the improvements is in excess of the remaining period of the lease. In such a case, in lieu of the allowance for depreciation provided by section 167, the basis shall be amortized ratably over the remaining period of the lease. See section 263 and the regulations thereunder for rules relating to capital expenditures.

(2) *Taxpayer using an accrual method.*—Under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy. However, any expenditure which results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year may not be deductible, or may be deductible only in part, for the taxable year in which incurred. While no accrual shall be made in any case in which all of the events have not occurred which fix the liability, the fact that the exact amount of the liability which has been incurred cannot be determined will not prevent the accrual within the taxable year of such part thereof as can be computed with reasonable accuracy. For example, A renders services to B during the taxable year for which A claims \$10,000. B admits the liability to A for \$5,000 but contests the remainder. B may accrue only \$5,000 as an expense for the taxable year in which the services were rendered. Where a deduction is properly accrued on the basis of a computation made with reasonable accuracy and the exact amount is subsequently determined in a later taxable year, the difference, if any, between such amounts shall be taken

into account for the later taxable year in which such determination is made.

(3) *Other factors which determine when deductions may be taken.*—(i) Each year's return should be complete in itself, and taxpayers shall ascertain the facts necessary to make a correct return. The expenses, liabilities, or loss of one year cannot be used to reduce the income of a subsequent year. A taxpayer may not take advantage in a return for a subsequent year of his failure to claim deductions in a prior taxable year in which such deductions should have been properly taken under his method of accounting. If a taxpayer ascertains that a deduction should have been claimed in a prior taxable year, he should, if within the period of limitation, file a claim for credit or refund of any overpayment of tax arising therefrom. Similarly, if a taxpayer ascertains that a deduction was improperly claimed in a prior taxable year, he should, if within the period of limitation, file an amended return and pay any additional tax due. However, in a going business there are certain overlapping deductions. If these overlapping items do not materially distort income, they may be included in the years in which the taxpayer consistently takes them into account.

(ii) Where there is a dispute and the entire liability is contested, judgments on account of damages for patent infringement, personal injuries or other causes, or other binding adjudications, including decisions of referees and boards of review under workmen's compensation laws, are deductions from gross income when the claim is finally adjudicated or is paid, depending upon the taxpayer's method of accounting. However, see subparagraph (2) of this paragraph.

(iii) For special rules relating to certain deductions, see the following sections and the

regulations thereunder: Section 1481, relating to accounting for amounts repaid in connection with renegotiation of a government contract; section 1341, relating to the computation of tax where the taxpayer repays a substantial amount received under a claim of right in a prior taxable year; and section 165(e), relating to losses resulting from theft.

* * * * *

U S GOVERNMENT PRINTING OFFICE